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BEFORE THE

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HOUSE OF REPRESENTATIVES

NINETY-SEVENTH CONGRESS

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ADMINISTRATION'S FISCAL YEAR 1983 ECONOMIC PROGRAM

THURSDAY, FEBRUARY 18, 1982

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The committee met at 2 p.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

[Press releases announcing the hearings follow:]

[Press release of February 12, 1982]

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES PUBLIC HEARINGS BEGINNING ON FEBRUARY 18, 1982, ON THE ADMINISTRATION'S ECONOMIC PROGRAM

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, today announced that the Committee on Ways and Means will conduct public hearings on the President's economic program, including tax and spending cut proposals, beginning with a panel of distinguished economists on February 18, 1982, to be followed on February 19 with testimony from representatives of a wide variety of economic interests.

The Committee will hear from David A. Stockman, Director of the Office of Management and Budget, and from Secretary of the Treasury, Donald T. Regan, on Monday, February 22. The Chairman of the Federal Reserve Board, Paul A. Volcker, and the Secretary of the Department of Health and Human Services, R;ichard S. Schweiker, will testify on Tuesday, February 23. On February 24, the Committee will hear from the Director of the Congressional Budget Office, Dr. Alice Rivlin. The Secretary of the Department of Labor, Raymond J. Donovan, has also been invited to give testimony on the afternoon of February 24. The hearings will begin at 2:00 p.m. on February 18; at 9:00 a.m. on February 19; and at 9:30 a.m. on February 22, 23 and 24. The hearings will be held in Room 1100 Longworth House Office Building, the Main Committee Hearing Room each day.

It is the intention of the Chairman that further hearings on the Administration's economic proposals will be conducted. Further announcements as to the time and scope of future hearings will be forthcoming.

[Press release of Wednesday, March 10, 1982]

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES PUBLIC HEARINGS WILL BEGIN ON MARCH 29, 1982, ON THE ADMINISTRATION'S REVENUE PROPOSALS

The Honorable Dan Rostenkowski (D., Ill.), Chairman of the Committee on Ways and Means, U.S. House of Representatives, announced today that the Committee will begin public hearings on Monday, March 29, 1982, on the revenue increase proposals included in the Administration's fiscal year 1983 budget and on other revenue raising initiatives. Other initiatives would include alternatives or additions to the Administration's proposals.

In announcing these hearings, Chairman Rostenkowski noted that "any effort to seriously address our current economic crisis must necessarily include initiatives to

increase federal revenues. The Administration has suggested some such increases, and while it is clear that controversy surrounds aspects of these revenue proposals, witnesses who oppose individual items are strongly encouraged to propose alternatives that the Committee should consider. All these initiatives should be given the serious legislative consideration which public hearings afford. These hearings have been scheduled at this time in order that the Committee may be in a position to act on substantive legislation at the earliest appropriate opportunity."

The hearings will begin at 10:00 a.m., Monday, March 29, and 9:30 a.m. on successive days. The hearing will be held in 1100 Longworth House Office Building.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

It is urged that persons and organizations having a common position make every effort to designate one spokesman to represent them in order for the Committee to hear as many points of view as possible. Time for oral presentation will be limited with the understanding that a more detailed statement may be included in the printed record of the hearings. This process will afford more time for Committee members to interrogate witnesses. The witnesses will be grouped as panels to expedite the hearings, and strict time limitations will be established for each panelist.

The following is an outline of the procedure to be followed by organizations and individuals who either may want to appear and testify during this hearing or file a written statement for the printed record of the proceedings. All requests should contain the following information:

1. The name of the witness, his title, address, firm affiliation and/or organization he will represent (as well as a telephone number where he or his designated representative may be reached).

2. If appearing in an individual capacity, a list of any clients at whose request or in whose employ the witness appears.

3. A topical outline or summary of comments and recommendations.

Requests to be heard must be made by telephone to Ms. Harriett Lawler [telephone (202) 225–3627] by the close of business, Monday, March 22, 1982. The telephone request should be followed by a formal written request addressed to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515.

Witnesses are required to submit 150 copies of their prepared statements to the Committee office, room 1102 Longworth House Office Building, at least 24 hours in advance of their scheduled appearance. Failure to comply with this rule may result in the witness not being allowed to testify.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

For those who wish to file a written statement for the printed record of the hearing, five copies are required and must be received by the close of business, Friday, April 16, 1982. These statements should contain the information listed in #1-3 earlier in this press release. The statements should be delivered to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. An additional supply of statements for the printed record may be furnished for distribution to the press and public if supplied to the Committee office during the course of the hearing.

[Press release of Thursday, April 29, 1982]

THE HONORABLE DAN ROSTENKOWSKI (D. ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, ANNOUNCES A ONE-DAY HEARING TO RECEIVE TESTIMONY FROM THE HONORABLE DONALD T. REGAN, SECRETARY OF THE TREASURY, ON REVISIONS TO THE REVENUE PROPOSALS CONTAINED IN PRESIDENT REAGAN'S FISCAL YEAR 1983 BUDGET

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means announced a one-day hearing to receive testimony from the Honorable Donald T. Regan, Secretary of the Treasury, on revisions to the revenue proposals contained in President Reagan's fiscal year 1983 budget. The hearing will be held Wednesday, May 5, 1982, beginning at 10:00 a.m., in the Committee's main hearing room, 1100 Longworth House Office Building.

In announcing this hearing, Chairman Rostenkowski made the following statement:

"While I am disappointed that the recent negotiations between congressional leaders and Administration representatives did not prove successful in reaching a formal agreement on all aspects of a revised budget package, the sessions did prove productive in developing a consensus on the magnitude of the deficit problem, the deficit reduction targets which we should attempt to achieve and the general categories in which budget reductions should be focused.

"As Presidential Assistant James Baker stated in his press conference of April 28, 1982, the President recognizes the need for increasing revenues by at least $122 billion over the next three fiscal years.

"The time for appropriate legislative action on revenue and other deficit reduction measures this year is quite limited. Therefore, I have requested the Honorable Donald T. Regan, Secretary of the Treasury, to present the Administration's specific recommendations for revisions in the revenue aspects of President Reagan's fiscal year 1983 budget on Wednesday, May 5, 1982.

"As Chairman, I have assured the Administration that the Committee on Ways and Means wants to cooperate with the President on this important national issue. To that end, I have reserved the entire month of May for the Committee to address this serious economic issue as well as the anticipated request from the Administration for an increase in the current ceiling on the national debt."

Chairman ROSTENKOWSKI. The committee will come to order.

Welcome to the committee, gentlemen.

We are grateful to you for participating in this discussion.

I have made some commitments to several of you that have to leave. So, I suggest that Mr. Stein begin the testimony. However I want to first point out that we have asked you here today to educate us on the broad state of the Nation's economy.

We want you to trace the decline of the economy, identifying the critical forces that brought on the current recession.

We would like your assessment of projected deficits in the budget proposal presented by the President of the United States and his recommendations to combat these deficits.

We are also particularly concerned with the impact of current economic policies on interest rates and unemployment.

You are all familiar with the legislative process and the political realities which govern that process. We look forward to your recommendations that address both economic and political realities this year, and, of course, in the years to come.

What I intend to do in most instances is to ask each of you to present your statement and at the conclusion of your statement, to engage in a dialog amongst yourselves, and allow us to interject any time that we feel we have missed something.

I will yield to Mr. Conable.

Mr. CONABLE. I have nothing to add to the chairman's dispassionate opening here. I am delighted to see so many peaks here, economic peaks, from which to survey the swamps in which we find ourselves, and I am sure that we are going to gain a great deal from the discussion among you gentlemen.

I greatly appreciate your coming here, and I realize it is an inconvenience to you. I am sorry it turned out to be a recess period and that the entire committee is not present to hear your discussion.

We rely heavily on the record here, gentlemen, and I hope that won't inhibit your conversation from which we all expect to learn a great deal.

Chairman ROSTENKOWSKI. We may even gain more from your interchange rather than from the questions posed by Members.

Gentlemen, we appreciate you coming here and joining us.

Dr. Stein, we will start with you, and then move across the panel.

STATEMENT OF HERBERT STEIN, PH. D., SENIOR FELLOW, AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH

Mr. STEIN. Thank you very much, Mr. Chairman, for your courtesy in allowing me to go first so I can get down to Richmond.

I am pleased to be here with my four colleagues on whom you can count to answer most of the questions in your letter, because I am not going to answer most of them, but will concentrate on a few points that seem to me of a special importance.

We are now living in the morning after the morning after about 20 years in which we have acted as if Government expenditures do not have to be paid for. It is the responsibility of this committee to represent the American people in recognizing that we must pay for these expenditures and in deciding how best to pay.

In the past, the country has been bemused by three theories which said that we don't have to pay:

One. The first theory said that increasing Government expenditures would raise the national income and thereby generate the added revenues and savings that would pay for the expenditures.

Two. The second theory said that the natural growth of the economy would generate additional revenue and savings—the so-called growth dividend—that would pay for increasing expenditures.

Three. The third and most recent theory said that cutting marginal tax rates would stimulate work, savings, investment and innovation which would, in turn, raise the national income and generate the revenues to pay for increasing expenditures.

There was something to all of these theories, but there was not enough in them to permit the Nation to increase Government expenditures as it has done without paying a real cost. The idea that merely raising expenditures would raise the national income enough to pay for the expenditures was good only when there were substantial unemployed resources. The growth dividend was real, but as soon as we got onto it, we raised expenditures by more than enough to use up the dividend. The supply-side effect of cutting taxes will not be large enough or fast enough to keep up with the expenditure increases.

So indeed we have been paying, and are continuing to pay, for Government expenditures, and have been paying in extremely bad ways. We have paid for the increase of nondefense expenditures by neglecting our defenses and weakening our national security. We have paid for the increased expenditures by absorbing a large fraction of the net national saving in financing the Federal deficit, which reduced economic growth. And we have paid for the expenditures by inflation, which raised real tax burdens even while nominal tax rates were being reduced.

That is, we have paid for a rapid increase of nondefense expenditures by weakening our national defenses, slowing down economic growth and inflating the economy. The essence of our present fiscal situation is general recognition of what has been happening, seri-

ous dissatisfaction with it, and a determination not to continue that way of paying for Government spending.

One response to the recognition of the cost we have been paying has been to slow down the rise of nondefense expenditures. This process was already begun in the Carter administration and was pushed much further in the first year of the Reagan administration. But what has been accomplished in this direction so far still leaves the budget in an extremely unsatisfactory condition.

If we do nothing but carry out the implications of existing tax laws and expenditure programs, we face large and rising deficits for the years ahead. That would mean, in my opinion, accepting slow economic growth for many years as a consequence of the absorption of private savings to finance the deficit. It would also mean an increased risk, although not the certainty, that inflation would accelerate again.

If that is not an acceptable course, and few people seem to believe it is, there are a limited number of options. The growth of nondefense expenditures can be cut further. The planned growth of defense expenditures can be cut. Taxes can be raised, to reduce the growth of private consumption and thereby increase the availability of resources for private investment and for Government use.

It is no solution to say that we will reduce the deficits by the growth of the economy. The deficits now foreseen already take account of as much growth as can be expected, and more. This is an especially unrealistic solution if the policy proposed will reduce growth, rather than accelerate it, as is likely to be true if the policy entails large deficits initially.

The approach taken by the administration's budget is to rely mainly on further slowing of nondefense expenditures, supplemented by relatively small revenue-increasing measures. In general, these proposals seem to me commendable. But they still leave deficits that are too large for too long, if our objective is to revive the growth of investment, productivity, and output. Even on the administration's assumptions of economic growth to be achieved in the next 5 years, which seem to me unrealistically high, the Government deficit would still be absorbing a large share of the net saving that would otherwise be available to finance private investment. The feasibility of the administration's projected growth path, and the significance of the projected deficit for investment, are discussed in the attached paper by Dr. William Fellner and myself which will be published in the AEI Economist.

A common proposal for supplementing or altering the administration's program is to cut defense spending. This is often supported by the argument that although the Nation's security must be the first priority, the Nation's security depends on its economic strength, which requires that the deficit be reduced or eliminated, and that, in turn, requires a cut of defense spending. This is all a great mistake. We have our economic problems in this country. But our weakness in the world, which is real, is not the result of economic weakness. By any measure that is relevant to our national security, the U.S. economy is very strong, and will continue to be so, whether we balance the budget or not. Our weakness is a weakness of will, including a lack of will to pay for the costs of defending ourselves.

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I believe it is important to bring the budget into balance soon. I believe that is less important than defending the country. Moreover, the budget can be brought into balance without cutting the defense program.

We need to push further on the two lines laid out in President Reagan's budget—cutting nondefense expenditures further and raising the revenues further. On the nondefense expenditure side, the obvious target is the more than $200 billion for social security. It seems to me hard to justify leaving these benefits, which far exceed what their recipients paid for them, untouched while benefits to much needier people are being reduced.

I know that there is a commission studying the social security problem with instructions to report in 1983. But now is the time when it is necessary to demonstrate the Government's final resolve.

There are aspects of the social security question—notably the indexing of benefits—which could be decided now and which would have large budget effects. For example, the Congressional Budget Office has estimated that holding the increase in benefits to two-thirds of the increase in the Consumer Price Index would reduce expenditures by $15 billion in fiscal 1985.

It will not be possible, however, to close all of our budget gap by cutting nondefense expenditures, and it would not be desirable to do so even if it were possible. I believe, for reasons which I explain below, that we should aim at balancing the budget by 1985 if the economy is operating at a feasible and satisfactory level.

To do this would require between $50 and $90 billion of additional revenue, after all the savings and revenue-enhancements recommended by the President and another $20 billion of expenditure cuts. The difference between $50 and $90 billion is the difference between CBO and budget estimates of the 1985 deficit under current programs.

There are various ways to raise this additional revenue. I will make one suggestion which seems to me to have several advantages. That would be to double the Federal excise taxes on liquor, beer, cigarettes, and telephone calls and raise the Federal gasoline tax by 50 cents a gallon. That would raise about $60 billion in 1985, of which about $50 billion would come from the gasoline tax.

This revenue increase would have minimum adverse effect on incentives to work, save, and invest. It would not unsettle those taxes whose stability is most important for the financial planning of individuals and businesses—which are the individual and corporate income taxes. The gasoline tax, which is absurdly low by the standards of most industrial countries, would be raised to a level which is helpful from the conservation standpoint. And now that the Government bears so large a part of the cost of the Nation's medical care, there is an argument for trying to reduce consumption of tobacco and alcohol by taxation.

It will be complained that this proposal would balance the budget on the back of the average American. That is true. There is no other back that can balance it. But if we fail to balance the budget, the burden of that also falls on the back of the average American and of his average children.

Why do I consider it so important to adopt a policy that would bring the budget into balance in 1985 under satisfactory and feasible economic conditions? The answer to that has two parts.

First, I consider it essential to have some rules of national fiscal policy by which we will live. Even if the rule that the budget deficit should be zero is not ideal, we do need some rule which will set a limit to the size of deficits and will require that when the Government increases expenditures it should also raise taxes. Otherwise, deficits and expenditures will be larger than anyone could reasonably want.

If some respected authority should come forward with a rule other than balancing the budget—for example, balancing a capital budget, or holding the deficit to 1 percent of GNP—that would deserve consideration. But I don't consider expressing a longing for a balanced budget to be such a rule. I don't see anything in sight that is likely to be a rule except balancing the budget. And if we want that rule to be effective, we should start behaving as if we took it seriously.

Second, the budget-balancing rule has a special merit in today's conditions. We have been through 20 years of increasingly large deficits which have contributed to the slowdown of the growth of investment and productivity. Moreover, we are engaged in a struggle to reduce the inflation rate which, for psychological reasons, if for no other, will be aided by elimination of the deficit. Thus, without commitment to a balanced budget forever, one can accept the need for balancing the budget in the 1980s.

I realize that it is easy for me to offer this prescription and hard for you to take it. I do not have to run for office, and you do. But there do come times when officeholders must do the hard thing, and this is one of them.

[An attachment to the prepared statement follows:]

THE BUDGET AND THE ECONOMY: A PRELIMINARY VIEW

(By Herbert Stein and William Fellner)

Forecasting the economy and the federal budget for several years into the future is, as the president has said, a hazardous enterprise. There are great possibilities for error in every part of such forecasts. Still, the law requires the president to make such forecasts. The reason for that is not at all arbitrary. The budget decisions made this year will have major effects several years from now. To make these decisions intelligently we must have the best possible estimates of their consequences, and we cannot describe these consequences without specifying the economic conditions under which they are assumed to develop. As everybody now knows, we cannot meaningfully say that the proposed budget decisions will yield a deficit of $82.9 billion in fiscal 1984 without describing the economic conditions under which the deficit would be that size. Without such specifications we know nothing about what the budget does and have no way of evaluating its merits.

This immediately raises the question of what economic assumptions are to be used in describing the consequences of the budget. There are several possibilities.

1. The budget could assume an economic path that, given the policies the administration is proposing, would make the budget look good. This generally means assuming enough inflation and/or economic growth to show that the budget will soon come into balance. This approach is always a temptation to budget makers, but it has largely been resisted. It would, among other things, destroy credibility.

2. The budget could assume the economic path that is forecast to be most probable. This seems intuitively the right thing to do; and for some purposes, say, for a private investor considering purchase of long-term bonds, it is the best thing to do. But it is not a position the government can take. For one thing the government is creating some of the conditions that influence how the economy will behave, so the

government cannot simply forecast the outcomes. It must also decide whether the forecast's most probable outcome is the most desirable one it could achieve with the available policy tools. That is, the government must forecast the best achievable path and try to attain it.

Moreover, to look at the budget as it would be under the most probable economic conditions introduces an uncertainty that is not only great but also needless. That is, to forecast whether 1984 will be a year of boom or recession involves great and needless uncertainty because our notions of the appropriateness of the budget outcome do not depend on such calculations. If it is the policy of the government, for example, to reduce the deficit year-by-year on a steady path, that does not mean the deficit should remain on that path if the economy falls into recession or soars into boom. For various reasons, we accept the variations in the surplus or deficit that come with economic fluctuations. What we want to know is the amount of the budget surplus or deficit under the most satisfactory of the feasible conditions of the economy. We recognize that in any single year the conditions may not be satisfactory and do not try to forecast the timing of cyclical fluctuations in the future.

3. We could assume that the economy moves along a feasible and satisfactory path and see what the budget outcome would be under these conditions. This would indicate whether the government's policy is consistent with achieving a feasible and satisfactory path and whether the policy will achieve the budget results that are desired when the economy is on that path. This would not deny the probability that in some years, and perhaps in most years, the economy will actually be off the path, in one direction or another. That would not necessarily mean that the budget policy is wrong.

For reasons that are clear from the discussion of the alternatives, we believes that the third approach is the sensible one. Moreover, it is the approach taken in this year's budget and in recent earlier ones as well. That is, the 1983 budget describes a path for the economy from 1982 to 1987. It defends that path as both feasible and satisfactory. It estimates what the deficit would be from 1982 to 1987 if the economy moved on that path. It then describes those deficits as being, if not satisfactory, at least acceptable and preferable to the steps that would reduce them.

Here we want to discuss two questions. Is the assumed economic path satisfactory and feasible, and what are the implications of running deficits of the size likely if the economy is on that path?

IS THE PATH FEASIBLE

The economic path forecast in the budget has several elements. From 1982 to 1987, real GNP would rise by 26 percent, or at an annual average rate of 4.7 percent. Unemployment would fall from an average of 8.9 percent in 1982 to 5.3 percent in 1987. Meanwhile, the inflation rate (measured by the GNP deflator), which was 8.6 percent during 1981 and is forecast at 7.2 percent during 1982, would fall to 4.4 percent during 1987. In our opinion it is important to reduce the inflation rate more rapidly than is done in the budget forecasts, even if that should entail slower growth of output for a period. However, we concern ourselves here only with the question whether the outcome projected in the budget is feasible.

The 1983 budget devotes a good deal of attention to demonstrating the feasibility of this projected path. Most of that attention is devoted to putting the projection of real growth into the historical perspective. One way to look at this question is to compare the projected growth path with the record over a long period of postwar history. Since we start in a year of recession, 1982, the 4.7 percent annual growth projected up to 1987 is not a fit basis of comparison. From 1979, a year of reasonably high employment, to 1987 the projection implies an annual average growth rate of 3.2 percent. This is well below the average of 3.6 percent achieved from 1957 to 1979.

This question is approached in the budget by comparing the twenty-two-quarter period from mid-1982 to the end of 1987 with all the (overlapping) twenty-two-quarter periods between 1946 and 1981. The projected growth rate for the period from mid-1982 to the end of 1987 is 4.7 percent per annum. In the 118 periods of equal length in post-war history, there were 22, or about 20 percent, in which the growth rate was 4.7 percent or more. From this the budget concludes that the projected growth is an achievable goal in view of the administration's policy initiatives—tax cuts, regulatory reform, etc.

There are two problems with this line of analysis. One is that periods of rapid growth, equal to those now projected, were not randomly scattered through the postwar period and have not appeared recently. Although, as noted, the average annual growth rate from 1957 to 1969 was 3.6 percent, the rate has been coming

down. It was 3.9 percent from 1957 to 1965, 4.0 percent from 1965 to 1969, 3.6 percent from 1969 to 1973, and 2.8 percent from 1973 to 1979. Thus, to achieve 3.2 percent from 1979 to 1987 requires a reversal of trend.

This point is even clearer if one uses the analysis of twenty-two-quarter periods employed in the budget. Of the twenty-two periods of that length in which real output rose as fast as in the budget projections, only nine occurred since the Korean War. The last of those nine ended in the fourth quarter of 1968—at the peak of the Vietnam war boom. In the past thirteen years, there has been no twenty-two-quarter period in which real growth was as high as 4 percent per annum. This again suggests how sharp is the projected break with recent experience.

A second problem may be more serious—the compatibility of the projected rise of real output with the projected behavior of prices and of nominal GNP. It is projected that while nominal GNP and real GNP are rising rapidly, the inflation rate will come down markedly. The issue is whether the inflation rate can decline even that much while nominal GNP rises so much, or whether real GNP can rise so much if nominal GNP is held down enough to enforce a marked slowdown of inflation.

From 1973 to 1979, nominal GNP rose by 10.5 percent per annum, and the inflation rate rose from 5.7 percent to 8.5 percent. It is now projected that nominal GNP will rise by 9.5 percent per annum from 1979 to 1985 and that the inflation rate will fall from 8.5 percent in 1979 to 4.7 percent in 1985. This seems a very slight slowdown in the growth of nominal GNP to bring about this change in inflation during a transitional period of adjustment.

An indication of the problem of consistency between the projected growth of real output and the projected decline of the inflation rate may be obtained by looking back at the years when real output did rise at the rate currently projected. We refer back to those twenty-two quarter periods that the budget used in its analysis. In each of the periods since the Korean War when real growth was as high as is now projected, the inflation rate rose.

In the past twenty years there have been only two years when the unemployment rate and the inflation rate both fell. One of these was 1972, when price controls were having their temporary effect. The other was 1976, when the United States experienced relief from the oil price increase. The budget projections call for five consecutive years, 1983–1987, in which both the unemployment rate and the inflation rate decline.

All of this suggests that the projected economic path is a sharp break with recent experiences, especially in the combination of inflation and real growth. Of course, a change from recent experience is needed, and it is the object of policy to bring that about. The question is whether the policies in place are likely to bring the change at a speed and in a degree that would be needed to yield the path for the economy projected in the budget, which in turn yields the forecast of declining deficits.

There is an interaction through the budget deficits between the prospective behavior of the economy and the prospective effectiveness of the policy designed to improve the economy. That is, the improvement of the economy—raising productivity, reducing costs, and permitting the real economy to rise rapidly while inflation subsides—depends on the growth of private investment, which includes almost all enterprise investment in the United States. But the growth of private investment depends in turn on the size of the deficit, because the larger the deficit the less savings remain available to finance private investment. If the economy cannot grow fast enough to yield the projected reduction of the deficit, private investment will be less than assumed in the projection, and growth will be even smaller than was projected. We now turn to the relation between the deficit and private investment.

THE IMPLICATIONS OF THE DEFICIT FOR PRIVATE INVESTMENT

The federal deficit and net private domestic investment both draw upon the same pool of resources, which consists of net private saving, the savings of state and local governments, and the net inflow of capital from abroad. The composition of this pool and its uses in 1981 are shown in table 2.

TABLE 2.—*Pool of available net savings, 1981*

	Billions
Sources:	
Net private saving	$156.1
State and local saving	36.5
Capital inflow	−2.3
Total	190.3
Uses:	
Net private domestic investment	129.1
Federal deficit	61.6
Discrepancy	−0.4
Total	190.3

Thus, in 1981 the federal deficit absorbed almost one-third of the pool of available savings.

If we want to increase the share of GNP going to net private domestic investment, we must do some combination of: (1) increasing net private saving as a share of GNP, (2) increasing state and local surpluses as a share of GNP, (3) increasing the net capital inflow as a share of GNP, and, (4) reducing the federal deficit as a share of GNP.

There is a strong probability that state and local surpluses will fall in the next few years, as the cut in federal grants increases the financial stringency of these governments. The net capital inflow has always been small relative to the numbers with which we are concerned here, and is often negative. Possibly a strong demand for funds in the United States, resulting from the deficit and the business tax changes, would raise U.S. interest rates and attract more capital from abroad. If that happened on a large scale, which seems unlikely, it would be embarrassing because it would imply a large increase of imports relative to exports.

For all practical purposes, therefore, we are left with increasing net private savings and reducing the federal deficit as ways to finance an increase of net private investment.[1] The administration's policy relies very heavily on a significant increase of net private saving, to be induced by the tax changes as an offset to the negative effect of large deficits. In this regard the conception is one-sided and, in our appraisal, unnecessarily risky.

Reducing the proportion of the savings pool absorbed to finance the federal deficit seems to us an essential component of a program aimed at increasing private investment. But the budget proposals would not accomplish this, even if the favorable economic conditions projected in the budget are realized and if all of the expenditure-cutting and revenue-raising proposals contained therein are adopted. For example, in our last year of reasonable prosperity, 1979, the federal budget absorbed about six-tenths of one percent of GNP. On the favorable assumptions just mentioned, the absorbtion in 1987 would finally have dropped to 1.3 percent of GNP–twice as much.

What this means may be seen in the following example. Suppose the government wishes to raise net private investment as a percentage of GNP to the level of 1979–6.7 percent-which is not a high figure that contributed to rapid growth. In 1985 the federal budget, on the official assumptions, would be absorbing 1.9 percent of GNP. If state and local surpluses fall from their 1979 level of 1.1 percent of GNP to 0.5 percent in 1985, as a result of the cutback in grants, net private saving of 8.1 percent of GNP is required. This is 50 percent more than it was in 1981 and 35 percent more than it was in 1979. These figures could be greatly increased by even moderately discounting the economic projections in the budget and the probable implementation of the deficit-reducing proposals it contains.

It has been suggested that the kind of analysis here developed should be qualified by recognizing that a rational buyer of the Federal Government's securities does not consider himself a saver to the full extent of these purchases. This is said to be so because the buyer needs to be aware not only of the interest payments he will receive from the government, but also of the inflationary loss which he will suffer as a result of the reduction of the real value of the government securities he is buying. According to this view, the savings going into private investment would therefore not be reduced by the full equivalent of the purchase of government securities resulting from the deficit. Yet this is not a qualification of much importance, because

[1] We assume that net private investment demand is sufficient to absorb the savings that would be available when the economy is operating under the most satisfactory of the feasible conditions, which we believe to be generally the case, though not every year.

households suffer an inflationary loss of real value not only on the Federal Government's securities but on a high proportion of the assets acquired by their savings as the latter are estimated in our national income accounts. If we wanted to adjust the saving concept for this, we would have to say that the public is generally saving at an even lower rate than the modest and recently reduced rate that our statistics indicate as the saving rate. The main reason for the overstatement of savings in our statistics by these standards is not a loss in real value attaching to the acquisition of assets created by deficits. These particular acquisitions divert savings largely from other channels that would also entail the same kind of inflationary loss in real value, and the public has not in fact made up this loss by additional savings as these are defined in the national income accounts.

As we said at the outset, projections of the economy and of the budget for several years ahead are subject to enormous uncertainties. We recognize the uncertainties in the calculations that we make here. But we believe that these calculations indicate the need for further examination and consideration of our fiscal options, which are still open.

Chairman ROSTENKOWSKI. Dr. Samualson you may proceed.

STATEMENT OF PAUL A. SAMUELSON, PH. D., PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. SAMUELSON. Mr. Chairman, I am glad to be here to testify.

The American economy is still in recession, our second recession within 2 years. Unemployment is up and expected to rise above the 9 percent level before it reaches its peak. Profits are down. Investment is down, not up.

When American families ask themselves, "Are you better off economically than you were a year ago?" the only answer they can give is, "No." The one bit of favorable news is that the outlook for the rate of inflation is better than it has been for several years: average prices now advance at about a 7 percent annual rate, not the double-digit rate of the late 1970's.

A nonpartisan panel of experienced economists must put part of the blame for our present situation on President Reagan's economic program. The administration's insistence last year on massive tax cuts has not led to the supply-side miracles it promised last year.

As many of us warned in testimony before this committee in early 1981, tax revenues would be lowered, not raised, by the reductions in rates. The big financial news has been the shift of Wall Street from enthusiasm over Reagan tax-cut goodies to hysteria over the indicated budget deficits ahead.

It is this virtual hysteria over the size of deficits in the 1982-86 period that explains the biggest economic news of the present epoch. What the 1981 data have to teach an older economist, the greatest surprise is the inexplicable height of real interest rates.

Interest rates are sky-high and are the immediate cause of our depressed level of business activity.

Real interest rates, the 15 percent you earn on long or short bonds corrected for a 7 or 8 percent rate of price inflation, are higher than they have been since the 1920s. Much that tax stimuli can do to stimulate investment in plant and equipment will be undone by real interest rates that stay at such magnitudes.

Putting aside radical-right supply-side zealots of the Kemp-Laffer stripe, and realizing that Wall Street hysterias run their short-term courses, the bulk of experienced economists expect the current recession to hit bottom by the middle of the year. What they

project is a modest recovery and not the vigorous expansion upon which the administration's forecasts and budgetings are based and not the vigorous expansions which are par in American history for business cycle recoveries.

Going on the evidence, I have to concur with this consensus view—but with the warning that economics is an inexact science and no one can rule out the possibility that the downward slide could turn out to be worse than now appears likely.

To blame President Reagan for all our ills is as naive as to blame President Carter for all America's earlier travails. The North American auto industry is suffering a long-term disease that goes far beyond the current ups and downs of the business cycle.

Even the luckiest of Federal Reserve monetary policies will not enable us to keep much of our traditional manufacturing industries from migrating to Japan, South Korea, and other successfully developing nations. As one sage has said: Unions are important in determining how certain industries die. What $8-an-hour foreign labor can do well will not continue to be done by $20-an-hour American labor.

Let me add that it is not good economic policy, and not defensible ethical humanism, to legislate import quotas to keep in existence elite manufacturing jobs that pay up to 50 percent above prevailing average American wages. The pressures will be very strong upon you, however, to do just that.

It is more French farce than Greek tragedy, although I am afraid it is a wry joke that we, the American people, have to suffer through, that a conservative President should have forced down the throat of a reluctant Congress programs that have lowered capital formation, decimated equity and bond prices, bled profits and profitability—to say nothing of lowering middle-class living standards and damaging the lower-income families.

Part of that may be the price of getting some inflation improvement, but it was not sold on that basis, nor was it bought on that basis, nor has there been sufficient discussion of whether the price is right on that issue.

What to do?

I believe that the 1983 installment of tax cut called for by the Kemp-Roth legislation should be declared to be uncertain at this time. The haste in doing so was to try to convert what was not yet a mandate from the American people to move idealogically to a more conservative direction, to strike while the iron was not hot; but we didn't have the information and the wisdom to decide that then, and I think that the doubts raised a year ago before this committee remain valid for the later period.

At this point in the game, I don't think the Federal Reserve has very many degrees of policy freedom now.

I believe it can prudently aim for the high part of its target range of money growth, thereby contributing a little bit toward bringing down our unnecessarily high real interest rates. If the American economy had turned out to be better in its investment, consumption, virtually unanimity would have prevailed among conservative and Democrat Party economics that that would have been a good thing, but, if the same thing were brought about by

Federal policy, that would have been deemed by half of this group as a bad thing, and not a good thing.

Finally, I do not believe that tax rates should be massively raised in order to lower a budgetary deficit that is, in part, the result of a recession in being. There are many reasons, including that the high interest burden, itself, is part of the legitimate burden which a Congress must legislate upon we, the people, to support in the future, but I think the main reason for the high employment deficit which moves ahead is because of the administration attempts to bring down spending by starving the Government for tax receipts.

Down the road some tax increases may well, therefore, be required, and I hope that these burdens will be fairly distributed, and, to correct a non-Freudian typo in my manuscript, that the tax changes will not be uniformly favoring my group, the upper middle classes, as 1981's tax reforms did.

The year 1981 will go down in history as the time in which ideological nonsense supplanted evidence in public policy discussion. As a forgettable Republican President once said, "It is time to return to normalcy."

Thank you.

Chairman ROSTENKOWSKI. Thank you, Dr. Samuelson.

Mr. ROBERTS. I have a short statement for the record, and I would like to read about five pages of it as my opening statement.

Chairman ROSTENKOWSKI. Your entire statement will be in the record, Dr. Roberts. You may proceed.

STATEMENT OF PAUL CRAIG ROBERTS, PH. D., SENIOR FELLOW, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES

Mr. ROBERTS. Mr. Chairman, distinguished members of the Ways and Means Committee, over the past decade the U.S. economy has shown signs of a variety of ills—rising inflation, declining productivity growth, a fall in the personal saving rate, and in general an economy afflicted with relatively high rates of inflation and unemployment simultaneously.

Over the last several years a fairly broad bipartisan consensus developed that the growth problems of our economy are related to a tax code that worked to encourage consumption rather than saving, investment, work and risk-taking. Last year's political battle over the tax bill should not obscure the fact that Democrats on the tax committees were in the forefront of the movement toward a supply-side economic policy with the reduction in capital gains taxation.

It was the Joint Economic Committee under the leadership of Senator Lloyd Bentsen, a Democrat from Texas, that in 1979 endorsed a supply-side policy with the first unanimous annual report in 20 years.

It was the Nunn Amendment to the tax bill late in 1978, pushed by the Democratic Senator from Georgia, otherwise known as "son of Kemp-Roth" that passed the Senate by a vote of more than 3-to-1.

It was the House in which the Democrats had a majority of 115 votes that then instructed its conferees to support the Nunn

Amendment. The Nunn Amendment, if you recall, combined personal tax rate reductions with reductions in the growth of Federal spending. It was Reaganomics before Reagan, passed by a Democratic Congress and lobbied against and killed in conference by a Democratic administration.

The electorate solved that problem in 1980 and put in office a President who wanted the same kind of economic policy that the Congress had already voted for 2 years previously. Once again, the Congress legislated the policy, this time with the urging of the President.

Unfortunately, the delay in implementing the new policy allowed the economy to be overcome by recession. As we all know, recessions mean budget deficits, and now the question has come up whether we should stick with the new economic policy in the face of the budget deficit, or instead take a page from the Hoover era and treat a badly performing economy with a big dose of austerity.

In answering the question we should keep in mind that in recent years the worse problem the economy has suffered under was not oil shocks and so forth, but rising uncertainty about the course of economic policy. To change course now before the new policy has even come into effect would not reassure any markets. It would signal instead that Government cannot stick to a course of action, resulting in worse uncertainty over the future course of economic policy.

The economy would not react favorably if the Congress focuses on the deficit and entertains higher taxes, instead of focusing on the recovery from the recession. No one is going to believe that tax cuts cause recession, or that tax cuts cause erratic and uncertain monetary policy, or that the proper treatment for the lack of economic growth is austerity and higher taxes.

The markets know that deficits are the normal accompaniment to recession, and that for at least 20 years the Congress and the economics profession have said that deficit spending is absolutely necessary in order for an economy to recover from recession.

To hear some of these same people talk now, you would think that the economy had never before experienced a budget deficit during a recession, and that there had never before been an economic recovery in the face of large budget deficits. But consider, for example, the recession of 1974-75. The economy came out of that recession in fine order, producing real growth rates of 5.4, 5.5, and 4.8 percent over the next 3 years in spite of very large deficits that measured 3.6 percent of GNP in 1975 and 4.5 percent of GNP in 1976.

By comparison, the 1982 and 1983 deficits are smaller, measuring 3.8 percent and 3.1 percent of projected GNP. Yet somehow these smaller deficits are supposed to prevent the economy from recovering from the recession.

The large deficits in 1975 and 1976 were financed without any help from tax law changes generating higher savings. In contrast, the revenues lost to the 1981 business tax cut and individual saving measures such as Individual Retirement Accounts result in increases in private-sector savings. The reductions in the marginal tax rates on personal income, scheduled for later this year and next year, will also have some positive impact on the personal saving rate.

The larger deficits in 1975-76, financed without the help of any saving incentives, did not prevent a recovery at a faster clip than the Reagan administration is projecting for 1983-84. Indeed, the administration's projection of a 5.2 percent real growth rate for 1983, the first year of recovery, is substantially below the average postwar recovery of 6.9 percent.

The attached bar charts to my testimony show that there is nothing unusual about the size of the projected budget deficits in relation to GNP or Federal borrowing requirements as a percent of private saving. Neither is there anything unusual about multiyear deficits. After all, the economy has a history of budget deficits for the past 20 years. Indeed, the participants in the financial markets know no other experience. They were born to budget deficits. I don't believe that they are all of a sudden panicked by them.

The source of panic, in my view, is the massive uncertainty about monetary and fiscal policy. Consider monetary policy. The administration's projections last year were based on the assumption that the Federal Reserve Board would produce a moderate, predictable, "on target" growth in the money supply. But the Fed was never within its target range.

In the early spring, the Fed was above target, reviving inflation fears. Then from April to October, the Fed was below its target, allowing the amount of money in the economy—measured by M-1—to actually fall by $300 million, helping to bring on a recession.

Now the Fed has again moved above its target, contradicting its words with its actions and creating the impression that the Government is going to inflate the economy out of the recession. Little wonder interest rates show signs of rising.

The volatility in monetary policy makes it difficult for market participants to know or guess what the monetary policy is or what direction it is going. It adds an uncertainty premium to interest rates. The greater the uncertainty, the greater the premium.

The attached chart shows the volatile monetary policy. It is beside the point for the Fed to say that U.S. monetary policy is less volatile than some other countries. The relevant point is that U.S. monetary policy is more volatile than before, so for U.S. financial markets there is a rise in uncertainty.

To underline the point about the uncertain course of monetary policy, on Thursday, February 11, 1982, both the Washington Post and the New York Times had the same lead front page story. The Post headline said, "Fed Plans to Ease Monetary Policy," and the Times headline contradicted it with "Volcker says Fed Plans to Continue Tight Money."

Uncertainty over fiscal policy is equally great. As soon as the tax cuts were passed, some administration officials and Members of Congress were raising doubts about them. For 6 months the campaign to raise taxes held a threat of unspecified tax increases over the economy, with no one in any market knowing on which productive activities new taxes might fall.

Some people are puzzled as to why the business tax cut has not spurred investment. But it is not so difficult to understand. Consider, for example, the corporate minimum tax proposal. It is perceived as an assault on the accelerated capital cost recovery and leasing provisions in the tax bill. As an economist, I would not

expect much business investment to take place until it is known which provisions stay in the tax law and which come out.

The talk about raising taxes also makes it look doubtful that the Government will succeed in controlling Federal spending. So do the latest budget figures. In spite of all the talk about tax and spending cuts, there is no evidence of either.

In 1982, Federal tax receipts—in spite of the tax cuts and the revenues lost to recession—will take a higher percent of GNP than in 1980, the last year of the high-taxing Carter administration. Spending, however, continues to mount, with each of the first 2 years of the Reagan administration holding successively the record for peacetime highs, rising from 23 percent of GNP in 1980 to 23.7 percent in 1981, and a projected 24.2 percent in 1982. These figures make it clear that to the extent the deficit is budget-related, it comes from the growth of spending.

In thinking about where to go from here, keep in mind the real mistakes of last year. A year ago, when the Reagan administration announced its program critics responded that the tax cuts were going to send the country up in the smoke of inflation.

These critics succeeded in frightening the Fed, the Congress and even some members of the administration. As a result, the Fed, fearing an inflationary fiscal policy, overcompensated on the monetary side, holding monetary growth flat for half of the year.

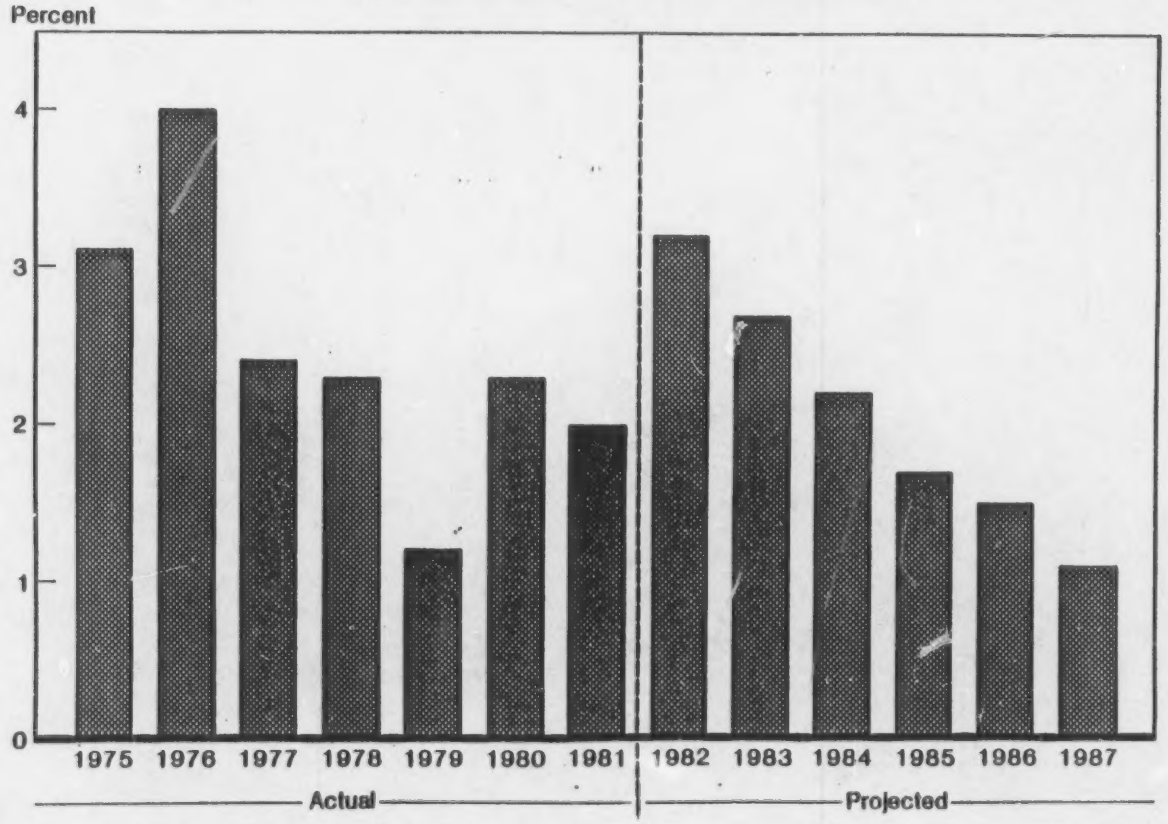
On the fiscal side, the administration and the Congress, in an attempt to keep tax revenues high and balance the budget, delayed and scaled back the personal tax cuts. Instead of the 20-percent tax reduction that was intended by January 1982, there was 5 percent, and it was overtaken by bracket creep. Consequently, there was a deflationary monetary policy and no tax cut, which guaranteed a recession and large budget deficits.

If you now respond to the budget deficits with more of the policies that produced them, you will move the economy from recession to depression.

Mr. Chairman, I hope that you and your party will remember the leadership role the Democratic Congress played in 1978–79 in helping to forge a new growth-oriented economic policy. When David Stockman and the majority over in the Senate get weak-kneed in the face of that old Republican bogeyman, the budget deficit, buck them up or step in and provide the leadership necessary to lead us back to a policy of economic growth and recovery from years of the wrong incentives.

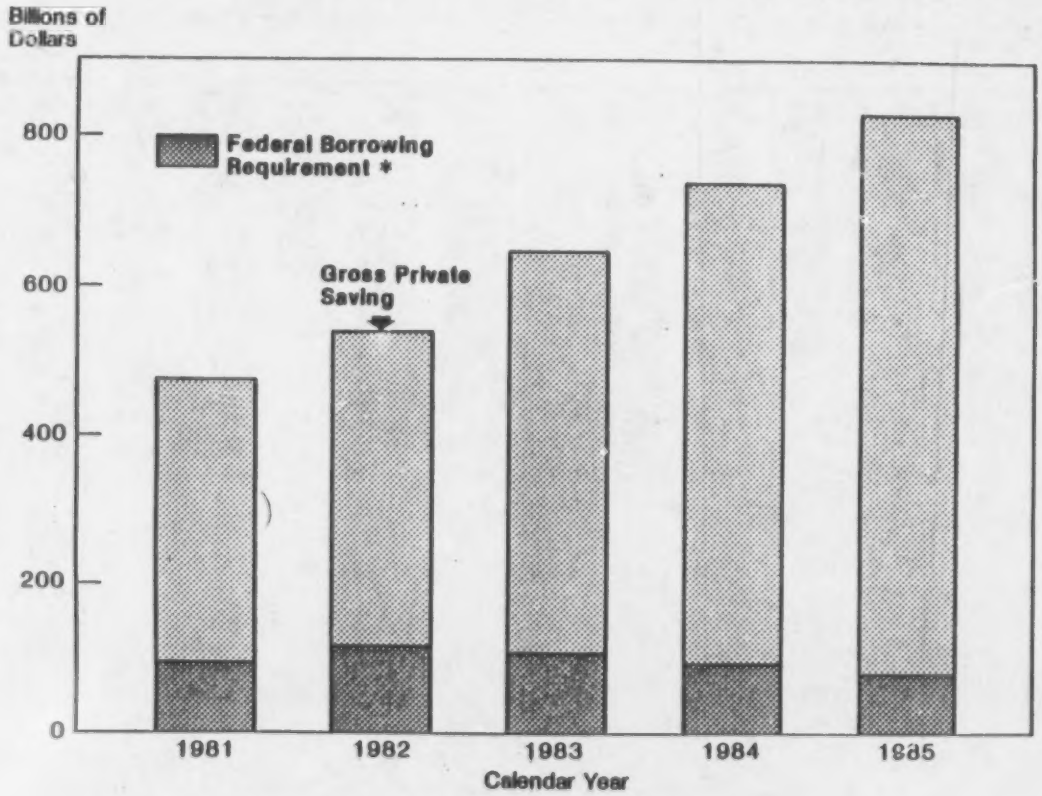
[The charts referred to follow:]

Budget Deficits in Relation to GNP*



* Unified budget deficit as percent of fiscal year GNP

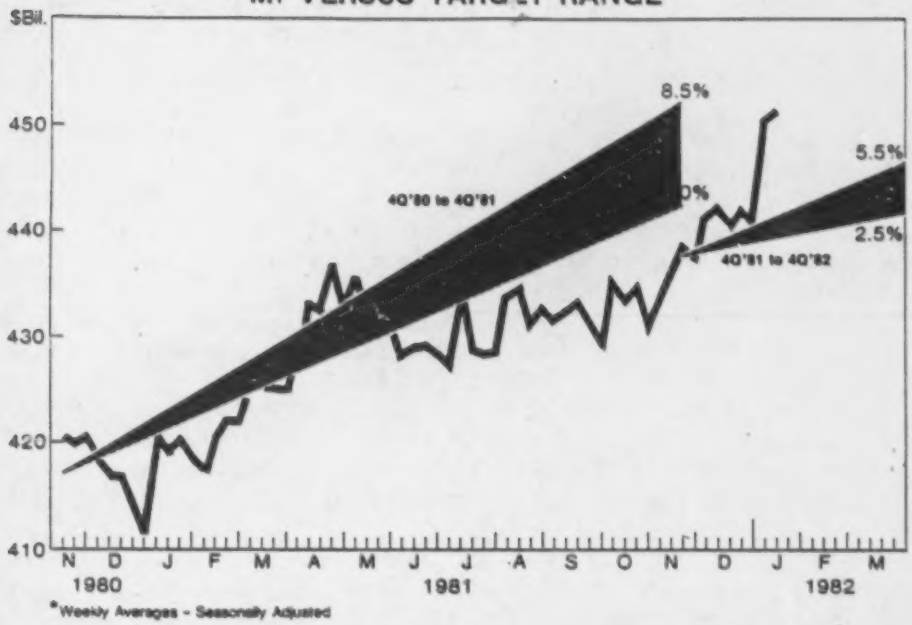
Projected Borrowing Requirement in Relation to Private Saving



* Total calendar year budget deficit including off-budget entities.

Note: Saving flows do not reflect surpluses of state and local governments or inflows from abroad.

M_1 VERSUS TARGET RANGE*



*Weekly Averages - Seasonally Adjusted

CHANGES IN MONEY SUPPLY (M_1) PEAKS TO LOWS			
Peak or low	**Amount ($bil.)**	**Change ($bil.)**	**Annual Rate of Change (Percent)**
1980			
Nov. 5-1980	419.1	*	*
Dec. 31-1980	411.4	-7.7	-11.9
Apr. 22-1981	436.7	25.3	20.0
July 1-1981	427.4	-9.3	-11.1
Sept. 16-1981	433.4	6.0	6.6
Oct. 28-1981	431.0	-2.4	-4.8
Jan. 13-1982	451.3	20.3	22.3

Chairman ROSTENKOWSKI. Dr. Pechman, you may proceed.

STATEMENT OF JOSEPH A. PECHMAN, PH. D., DIRECTOR OF ECONOMICS, BROOKINGS INSTITUTION

Mr. PECHMAN. I, too, will summarize my statement, and I hope it will be included in the record.

It is unusual for me to be on the right of Paul Craig Roberts, but this morning I am.

I agree with Herbert Stein and Paul Samuelson, and disagree with Paul Craig Roberts, that the deficits that are now impending are a major, if not the major, problem of economic policy in the years ahead.

The official estimates of the Reagan administration suggest that the deficits will go down from something like $98 billion this year to a little over $70 billion in 1985.

Those estimates are based on very, very generous economic assumptions, and also assume that every bit of the economic and budget program of the administration will be enacted. In addition, it is assumed that, what they euphemistically call management initiatives, would be realized in full.

When the budget is priced out realistically, the actual deficits that face you are far larger than those that you see in the budget.

In fact, for fiscal year 1984 or 1985, you can just about double the official figures, and you will be closer to appreciating the extent of the problem than the numbers you find in the budget.

I make this statement on the basis of just three separate adjustments. First, the administration's projections assume a very sharp recovery from the current recession, and then thereafter a maintenance of economic growth, that if realized, would equal the rate of economic growth in the heyday of the early 1960's.

The budget, itself. points out that the economic growth that it envisions will be substantially higher than the average economic growth over the past 20 years.

The budget document provides alternative estimates on the basis of more modest assumptions of growth. Those alternative economic assumptions add something like $35 billion to the deficit in 1985.

Another adjustment that has to be made is for the likelihood of the so-called management initiatives to be realized.

For example, the management initiatives include large increases in sales of Outer Continental Shelf lands for purposes of exploring and developing oil. I am not an expert in these matters, but it is hard to believe, that, in the face of declining oil prices and declining oil demand, it is difficult enough to believe that recent trends will continue, but to add to it by an average of $7 billion a year for the next 3 years is hard to imagine.

Similarly, the management initiatives include generous estimates of Federal asset sales during the next 3 years.

The budget assumes something that I would like to see done, and something that you, yourselves, have approved at least three times, namely, the adoption of withholding on interest and dividends.

It also includes a speed-up of corporation tax payments, and so on.

These management initiatives add up to $20 billion 2 years hence, an amount that should be discounted at least 50 percent.

Finally, the program of cuts in spending that is outlined in the budget is extreme. I certainly hope that the Congress will look at these cuts very carefully to see that the disadvantaged groups are not clobbered again as they were last year, and that the new federalism which is intended to transfer responsibilities to the States and local governments does not begin with grants-in-aid that are about a third lower than they were in 1981, as is envisioned in the budget.

If you make corrections for these things, you find that the budget deficits don't go from $98 to $72 billion, but rather go from $110 billion to well over $150 billion.

Paul Craig Roberts is just dead wrong when he says that these are small deficits. Out there in 1985, the economy would be operating at a very high level under the assumptions I have made. Unemployment would be much lower than it is today, and, while it would not be operating at what I regard as full employment, most economists would agree that the ratio of the budget deficit to the GNP should be lower than what it is during a severe recession, as it is today. In fact, the ratio of the deficit to GNP in 1985 is something like 3½ percent, which by historical standards is extremely high for levels of income and employment projected at that time.

I agree that we should not try to balance the budget during a recession, but I do think that you have to worry about what happens 2 or 3 years out. Unless you take action this year, you are not going to be able to reduce those deficits significantly.

The major reason I am worried about the budget deficit is because it reduces national saving. A deficit means that the Federal Government is dissaving, drawing down private saving which could otherwise be used for private investment. Under the circumstances expected in 1985, it would be crowding out private investment which, I think, is necessary for increased economic growth.

What to do?

Well, it is clear that the tax-cutting spree that the Congress went on with the administration last year was ill-advised. You just cut taxes too much, and you must restore a major share of the revenue potential of the Federal tax system to avoid economic calamity.

I agree with Paul Samuelson that the easiest thing to do would be to defer the 1983 tax cut until the time that we can afford it. At the same time, I would also defer the indexing provision that would go into effect in 1985.

This action alone would, if my memory serves me correctly, increase receipts by $53 billion in fiscal year 1985.

In addition to that, I think it is time to do much more than the administration suggested, to clean up the inequitable, inefficient tax expenditures in the code.

You can raise revenue, improve the allocation of resources, and increase the fairness to the tax system by doing away with the inefficient and uneconomic provisions that are now in the law.

As you know, the administration, itself, has recommended tax revision proposals, that would add $16.6 billion of revenue in 1984, in 1985, it would be $15.8 billion.

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I would add to these very substantially. My table 1 gives a suggested list of additional tax expenditures that could be eliminated.

It starts with eliminating the 1981 saving provisions which I do not believe will increase net savings at all. These account for part of what Paul Samuelson said was the largest that you gave to the upper middle classes.

Early this year, my wife and I each transferred $2,000 from one account which was taxable to another account in the same mutual fund labeled IRA, and we got a $2,000 tax cut from that. There was no increase in saving. I dare say that most of the people who are attending these hearings have already transferred enough funds to get that saving. But the amount of net saving that you got out of such transfers is small. I predict that the amount of net saving you will get out of IRA's will be small, too.

The interest provision that you enacted for 1985 will not increase saving. It is true it will reduce the marginal rate on interest receipts, but the provision is defective. It gives tax advantages to people for increases in interest rates, as well as for increases in saving.

As some of you know, I have pointed out that if you really want to provide an incentive to save, you have to go to a device which would require a computation of net saving for each tax return.

I think it is possible. I am not suggesting that you do it, but if you do want to have a saving incentive, the way you now do it is just wrong, and you ought to eliminate these unnecessary provisions.

I would also eliminate the tax exemption for all industrial development bonds rather than for just those that the administration suggested. There is in addition a whole list of tax expenditures which adds up to close to $40 billion in 1984 and to $50 billion in 1985. The entire list adds up to close to $60 billion. It seems to me that you could add quite a bit of revenue if you really tried hard to clean up the Tax Code.

I think that it is possible, without impairing the recovery, to add to the receipts of the Federal tax system in 1985, something like $50 to $75 billion.

You would be doing the economy a good turn. You would be improving the fairness of the tax system, and promoting economic growth which is so desperately needed.

Chairman ROSTENKOWSKI. Thank you, Dr. Pechman.

STATEMENT OF JOSEPH A. PECHMAN, PH. D., DIRECTOR OF ECONOMICS, BROOKINGS INSTITUTION

I am pleased to have this opportunity to discuss with this committee some of the difficult issues in current tax policy. In this statement, I will discuss briefly the economic and budget outlook, the saving and investment provisions enacted in last year's tax bill, and the range of choices for raising additional revenue.

THE ECONOMIC AND BUDGET OUTLOOK

The Reagan team disregarded budget deficits in making its plans for the next several years. Hence they were able to persuade themselves that taxes could be cut by more than expenditures, without serious economic consequences. But they forgot that the tight monetary policy—which they support—would collide with their loose fiscal policy (i.e., continued high deficits). The result has been high interest rates, which brought on the current recession and will continue to regard the growth of the economy.

Assuming there is no incomes policy to reduce the rate of growth of wages and prices directly, the only mechanism that remains to combat inflation is to restrain the growth of money and credit, which then slows down the economy. If this policy is maintained for a long enough period of time, wages and prices will respond. But, as the current experience amply demonstrates, the cost of this policy is very, very high in terms of lost output and unemployment.

Federal deficits exceeding $100 billion a year are now in prospect for the foreseeable future. While not a cure-all, reduction and eventual elimination of these deficits would help to ease interest rates and thus to moderate the effect of monetary policy on the economy. In addition, elimination of the deficit (which is really dissaving by the federal government) would increase saving and thus permit a larger increase in investment, which may help to stimulate productivity growth.

THE SAVINGS STIMULUS

The 1981 act included a number of provisions that were intended to stimulate saving. These are: (1) an all-savers certificate which provides $1,000 of tax-free interest per person for investments made in savings and loan associations and banks during the period October 1, 1981 through December 31, 1982; (2) a deduction for investment in individual retirement accounts (IRAs) of up to $2,000 per person, regardless of whether the individual is already covered by a pension plan; (3) an increase in the allowable deduction for Keogh plans for the self-employed from $7,500 to $15,000 a year; and (4) a deduction of 15 percent of net interest paid up to $3,000 ($6,000 on a joint return) beginning in 1985. In addition to these special provisions, the supply-siders expect a significant effect from the rate cuts on saving, but there is no evidence that the additional disposable income will be divided very differently between saving and spending than current disposable income.

The effect of the savings gimmicks will also be disappointing. Except for the all-savers certificates, there is no prohibition of the use of borrowed money to obtain the additional tax benefits. Moreover, it is always possible to switch assets from one place to another in order to take advantage of the tax savings. None of this, of course, will result in any additional net saving.

As I have already indicated, the best way to increase national saving quickly is to balance the federal budget. However, if there is a desire also to increase private saving, the best way to do that is to provide a reduction or credit directly for net saving. Such a deduction is feasible and would be much more effective than the present (expensive) gimmicks in the tax law, which should be repealed. The attached article from the Washington Post explains this idea in somewhat more detail. (Senator Bradley introduced the net saving credit during the debate on the 1981 Act; the amendment received 15 votes.)

THE INVESTMENT STIMULUS

The greatly liberalized depreciation provisions which were enacted in the Economic Recovery Tax Act of 1981 are a slight modification of the 10–5–3 proposal endorsed by President Reagan during his can paign last year. The objective of this new system of depreciation was to stimulate incentives to invest and to offset the erosion of depreciation allowances resulting from inflation.

It would have been fairer and simpler to provide an immediate deduction for the cost of investment in lieu of depreciation. Such an "expensing" provision is no more costly than 10–5–3, automatically takes care of the inflation problem (since the depreciation deduction is taken in the same prices that prevail when the investment is made), and in effect eliminates the impact of the corporate tax on the rate of return from productive assets. (For example, a 50 percent corporate tax cuts the rate of return in half. If expensing is allowed, half the cost of the asset is recovered immediately; thus, the corporation earns half the original rate of return on half the investment, which means that the pretax return is restored.)

It was discovered (too late, it turned out) that the 10–5–3 plus the investment credit was more generous than expensing for many assets and less generous for other assets. This means that the present provisions actually subsidize investment in some cases while taxing investment in others. (For estimates of the degree of non-neutrality among different assets and industries, see the Economic Report of the President, February 1982, pp. 124–25.) Such non-neutral treatment will inevitably lead to a misallocation of resources. By contrast, expensing is neutral in its effect among assets.

Although the advantages of expensing over 10–5–3 were well known, the administration and its supporters did not budge from their support of 10–5–3 because so

much political capital had been spent on it. As a consequence, the expensing provision in the House Ways and Means Committee bill went down the drain.

It is unfortunate that expensing fell by the wayside. Businessmen will soon learn that the 10-5-3 proposal is actually much more complicated and does not take care of the inflation problem. Expensing is certainly the peferrred alternative.

The safe-harbor leasing provisions which were enacted last year have been attacked by many as give-aways to large corporations. These provisions permit corporations with insufficient profits to sell their investment tax credits and net operating losses to other firms which can use them to offset their tax liabilities. Leasing is a substitute for refundable credits, but it is an inefficient way of obtaining the effects of refundability. It would be better to repeal the 1981 leasing provision and substitute refundability instead. If Congress does not wish to extend refundability to some "undeserving" firms, it should be easier to deny them benefits under refundability than under leasing.

RAISING ADDITIONAL REVENUES

We are all painfully aware now that the 1982 tax reductions will reduce the revenue potential of the federal tax systems in 1981-84 by more than we can afford. In addition, the indexation of the individual income tax which was incorporated in the law effective in 1985 was a major fiscal blunder. It will reduce federal receipts by $13 billion in fiscal year 1985, $36 billion in 1986, and so on.

It is now clear that neither the administration nor the Congress will be able to reduce defense and nondefense expenditures by a sufficient amount to get the federal budget anywhere close to balance in the next several years. Accordingly, we must look for new sources of revenue to reduce the very large deficits that are now in the offing.

There are several methods of increasing taxes, some better than others:

1. A traditional method would be to increase excise taxes on tobacco, alcohol, gasoline and telephone service. Except for the gasoline tax, the revenue potential of excise taxes is not great: even if all the major excises were doubled, the revenue increase would be about $10 billion in fiscal 1984, and $11 billion in fisal 1985. Moreover, tobacco and alcohol taxes are generally regressive and increases in these taxes are resisted by the public. A substantial increase in the gasoline tax would be appropriate to promote conservation, but this is also greatly resisted by the public. If excise taxes are increased, tax increases should also be imposed at the higher income classes to offset the regressive effect of the excises.

2. As natural gas is deregulated, a windfall profits tax similar to the tax now levied on production of oil would be appropriate. Such a tax would not raise as much revenue as was once thought; the Congressional Budget Office estimates that the net revenue gain from a windfall profits tax on natural gas could be as low as $6 billion in fiscal 1984. President Reagan opposes the windfall profits tax, but he might reconsider after reviewing the alternatives.

3. Another possibility is to enact a value added tax. This tax is, of course, highly inequitable as compared to an income tax, since it is regressive or, at best, proportional. The experience of politicians with the value added tax is not good, but some may turn to this tax if the revenue situation becomes desperate. I hope that Congress will avoid this alternative. The enactment of a value added tax after the large income tax reductions made last year would be a clear indication that the real purpose of recent tax policy has been to reduce the progressivity of the tax system.

4. The best way to increase revenues in the future is to eliminate many of the irrational, uneconomic, and inequitable tax expenditures. The administration recommends several revisions that would raise about $11 billion in 1983 and more than $16 billion in 1984 and 1985. I think that the goal should be to raise at least $50 billion by this means. A list that would easily raise this amount in 1984 and 1985 is given in Table 1. This approach would raise urgently needed revenues and improve horizontal and verticle equity at the same time.

5. Since the huge 1981 tax cuts are major causes of the deficits now in prospect, it would be appropriate to delay or repeal the July 1983 cuts and the indexation that goes into effect in 1985. This would increase revenues by about $37 billion in fiscal 1984, $54 billion in 1985, $76 billion in 1986, and $102 billion in 1987, and would be timed fairly well from the standpoint of countercyclical policy. It would also be useful to accelerate the July 1982 tax cut by three months. The reduction in revenues of $7 billion would help to accelerate recovery from the present recession.

Over the longer run, it will be necessary to review the structure of the income tax to see whether it can be improved sufficiently to remain the major source of revenue for the federal government. I believe that, by eliminating unnecessary deduc-

tions, exclusions and tax credits, it would be possible to make the tax much simpler and more equitable than it is today and cut the tax rates well below the rates now scheduled to take effect in 1984.

Some people argue that the income tax shold be replaced by an expenditure tax, since we are already providing tax shelters for a large percentage of property income. However, there is no assurance that, in practice, an expenditure tax would be closer to an ideal tax than the income tax. Moreover, abandonment of the income tax would increase the concentration of income and wealth. It would be better to work to improve the preference-ridden income tax than to enact a new tax which will not promote the nation's social and economic objectives.

TABLE 1.—REVENUE EFFECTS OF VARIOUS TAX REVISION MEASURES, FISCAL YEARS 1984–85

[In billions of dollars]

Item	1984	1985
Administration proposals:		
Revised contract accounting	5.0	3.2
Remove business energy tax credits	.4	.6
Limit tax-exempt revenue bonds	.3	1.1
Eliminate modified coinsurance	2.2	2.5
Amortize construction period interest and tax	1.1	1.0
Enact corporate minimum tax	4.6	5.1
Speed up corporate tax payments	1.7	0.9
Withhold on interest and dividends	1.3	1.4
Subtotal	16.6	15.8
Additional proposals:		
Eliminate 1981 act saving provisions	2.0	5.6
Eliminate tax-exemption for all industrial development bonds	3.6	3.7
Repeal percentage depletion	1.6	1.9
Terminate deductibility of consumer interest payments	7.8	8.1
Limit home mortgage interest deductions to $5,000	1.0	1.3
Terminate deductibility of state and local sales taxes	5.3	6.0
Tax one-half of social security benefits	9.6	11.3
Tax all unemployment insurance benefits	1.7	1.7
Limit tax-free employer contributions to health plans to $120 a month	3.3	4.4
Raise the threshhold for medical expense deduction to 10 percent and eliminate separate deduction for health insurance premiums	3.0	3.2
Subtotal	38.9	47.2
Total revenue effect	56.5	63.0

Source: "Budget of the U.S. Government, Fiscal Year 1983," pp. 3–12, 3–15, and 4–9; and Congressional Budget Office, "Tax Expenditures: Current Issues and 5-Year Budget Projections for Fiscal Years 1982–86 (September 1981)."

[From the Washington Post, June 14, 1981]

Taxes Versus Savings

(Joseph A. Pechman)

A major goal in the tax debate is how to use tax cuts to stimulate individual saving. The Reagan administration asserts that a 30 percent across-the-board cut in marginal tax rates will raise saving sharply. But there is no evidence to suggest that taxpayers would save, other than temporarily, much more than 5 to 8 percent of their increased net incomes, the proportion of disposable income saved since 1950.

The Democrats propose cuts "targeted" to promote saving, but their aim has been poor. They would increase deductions for individual retirement accounts (IRAs) and Keogh plans, and some would add new deductions for special savings accounts set up to accumulate the down payment for a house or to pay college tuition, or increase the amount of dividends and interest or long-term capital gains not subject to tax.

Such proposals have the fatal flaw that they reward people who borrow money or switch prior savings into the tax-favored assets, without necessarily doing any new saving. The present $200 exclusion for dividends and interest ($400 for a married

couple)—which was enacted effective Jan. 1, 1981, for two years to increase saving—has had no noticeable effect. In fact, the saving rate has declined slightly since this provision went into effect.

If we are serious about increasing total national saving and not merely private saving, the most direct way would be to move toward a surplus in the federal budget. For each extra dollar the government reduces its borrowing, a dollar more of lendable funds is available for private investment. In contrast, each extra dollar of federal deficit drains a dollar from private lending, while only a small part of the tax-cut dollar received by individuals is saved.

But if it is agreed that individuals should be encouraged to save more, the best solution would be to give people a deduction or tax credit for their saving and to let them decide how to invest it. This approach neither promotes consumption, as do across-the-board cuts, nor distorts savings patterns, as do the miscellaneous devices now under discussion.

Economists and tax lawyers have devised a method of calculating saving—the cash flow approach—which is both simple and fair. Taxpayers would list on a separate schedule their purchases of financial or business assets, the payments on the principal of a home mortgage and increases in bank and savings deposits during the year. From the total of these items, they would deduct sales of financial or business assets, reductions in bank and savings deposits and increases in borrowing. The difference between these two sets of figures is net saving.

As a starter, taxpayers could be allowed to deduct net saving up to some fixed amount, say, $2,000 for a single person ($4,000 for a couple), or they could be given a tax credit of, say, 20 percent of these amounts. These limits could be increased in future years. The tax credit has the virtue of giving the same tax cut to individuals who save the same amount, regardless of their tax bracket. A 20-percent credit would halve the tax rate on income saved by taxpayers in the 40 percent bracket and eliminate tax on saving for taxpayers in the 20 percent bracket. The cost of such a credit would be about $3.5 billion if saving did not increase.

The precise effect of the credit on saving cannot be estimated, but it could be significant. If 10 million people saved $1,000 more than they otherwise would, total saving would rise by $10 billion—an 11 percent increase in personal saving at current rates—and reduce revenue by an additional $2 billion. More than half of the total revenue loss of $5.5 billion could be offset by repealing the dividend and interest exclusion, which costs more than $3 billion a year.

Although a tax incentive is simple in principle, it would be vital in practice to define saving accurately to forestall creation of still another tax avoidance device. Considerable thought needs to be given to such problems as the treatment of saving and dissaving in successive years, gifts and bequests and the classes of assets eligible for the credit. These problems can be solved.

The administration and Congress are unlikely immediately to embrace the tax credit proposal and to do the necessary technical work in time to include it in the pending tax bill. But much would be gained if the seriously flawed ideas for stimulating saving now under discussion were shelved pending the development of a detailed general savings incentive. The tax staffs of the Treasury and the Joint Committee on Taxation could be directed to work out a feasible plan for the congressional tax-writing committees by late 1981. It would be better to take a few more months to enact a law that can work than to be stampeded into enacting a law that will waste scarce tax resources and is doomed to fail.

Chairman ROSTENKOWSKI. Dr. Feldstein, you may proceed.

STATEMENT OF MARTIN FELDSTEIN, PH. D., PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Mr. FELDSTEIN. I have a statement for the record which is too long to read, but I would like to summarize the first part of it, and then read the last few pages.

The statement I have submitted to you begins by reviewing some of the progress that has been made in the last couple of years.

It is useful to do, so as to end the excessive pessimism that hangs over this town and over most of the country.

Certainly the most tangible bit of progress has been the substantial reduction in inflation.

It is easy to forget now that just about 2 years ago, the Consumer Price Index rose 1 month by 18 percent, and there was a general feeling of panic that perhaps the economy and the price level had gotten out of control.

By comparison, last year, the CPI increase was less than 9 percent, and, for 1982, we can expect an even lower rate of inflation by that measure or other measures.

The lower rate of inflation, itself, is a result of the recession that we have had, and, therefore, of the tight money policy that the Fed has pursued.

Nobody likes a recession, but it is the only way we really know for bringing down the rate of inflation, and I would say the rate of inflation has come down much more rapidly in response to this past year's recession, and most of the skeptics felt at an earlier time.

The question is, will that decline in inflation continue? All of the fundamental factors in product and labor markets say yes, but the financial community is worried about whether the inflation rate will turn up again, really worried about how the Fed is going to respond to these deficits and to the pressures that they may receive from the administration, and from Congress to increase the rate of growth of the money supply outside their target path.

It is the fear of that inflationary policy change by the Fed that is keeping real interest rates as high as they are now.

Everytime a leading supply-sider suggests an easy money policy, the financial markets get very worried that the President may take him seriously, and that the interest rate, therefore, will be even higher in the future.

I think the key to bringing down the high, long-term interest rates is to reduce the fear of inflation.

Lower projected deficits, of course, would help, but not nearly as much as a clear feeling that the Congress and the administration are backing the Fed's steady policy.

Let me turn to deficits.

If the Fed pursues its steady monetary policy, the real problem of deficits will not be inflation, but rather a reduction in the rate of investment. A hundred billion dollars of deficits in 1984 would be 2½ percent of GNP in that year. Net investment is now only 6 percent of GNP, so that 2½ percent really looms quite large as a potential loss, even though it may be in part offset by the savings incentives that Congress passed last year, which I feel, unlike Dr. Pechman, are going to help.

We will still see a substantial reduction in net investment from what it otherwise would be.

The loss of investment is the real reason for wanting to eliminate the deficits. Let me point out that that can happen; that loss of investment can happen, even without the rise in interest rates that many Wall Streeters are so terribly worried about these days.

If inflation recedes because of a perception that monetary policy will continue along its sound track, inflation premium and interest rates will drop; so, even if the deficit raises real interest rates by a bit, the inflationary pressure coming down, the inflation premium falling, will cause market interest rates to fall.

That is not well understood, and it leads to the kind of temporary hysteria that Paul Samuelson talked about before.

Another important confusion is the notion that large deficits will abort the recovery.

That is just wrong.

It is, of course, true that a large deficit, by raising the real interest rate, will reduce spending for plant and equipment, new housing, and for some durables.

However, a larger deficit also does mean either more government spending or lower taxes, and, therefore, more consumer taxes, or both of those, thus providing a direct addition to demand that can stimulate and sustain the recovery.

The real problem is not that deficit will produce sky-high interest rates or abort the recovery. The real problem is that substantial deficits could eliminate a significant portion of net capital formation, not in the current recession, but over that prolonged period for which deficits now are projected. This adverse effect on capital formation which could occur even if the rise in the real interest rate is small, is the important reason to reduce the projected deficits for the next few years and to bring the budget into balance within 5 or 6 years.

I believe, moreover, that such a policy can be designed without rescinding either the business or the personal tax reductions that were enacted in 1981.

The key to such a balancing of the budget is to slow the growth of Federal nondefense spending until these outlays equal the same 13 percent share of GNP that they did in 1970, hardly back to the Dark Ages.

Returning nondefense spending to 1970's 13 percent share of GNP over the next 6 years would require a 12-percent decline in the real level of nondefense outlays, back to the real level of nondefense outlays that prevailed as recently as 1978.

A combination of a 2 percent reduction in nondefense outlays and a 3½ percent real GNP growth well below the administration's forecast and below the experience of early recovery periods in the past; that combination, 2-percent-a-year real reduction, plus 2½ percent real GNP growth, would be sufficient to bring nondefense spending back to 13 percent of GNP in 6 years.

A 2 percent annual reduction in real nondefense outlays can be achieved most fairly and with the least disruption by making changes in the full range of Government programs. Unfortunately, the administration has refused to make any significant changes in the social security retirement, disability and medicare programs that currently account for some 40 percent of nondefense spending.

It is, therefore, up to Congress now to broaden the range of spending reductions, not in order to cut spending by more than the administration proposed, but to distribute the spending cuts in a way that is both fair and more likely to achieve legislative approval.

To me, the most important change would be to modify the social security indexing rule, raise benefits only for price increases in excess of 2 percent, a proposal that I made to this committee, but certainly to the Joint Economic Committee last fall, which would save nearly $20 billion in 1986.

Recent proposals by Senators Hollings and Domenici, limiting the excess to over 3 percent, and extending to all in direct benefits, would achieve about one-fifth of the entire reduction that is needed by 1986.

In the prepared statement I discuss other changes in nondefense spending, particularly in medicare and disability insurance and in defense spending, as well as some specific revenue-raising changes and tax rules. To save time I will skip over these now, but I hope you can return to some of them during the question-and-answer period.

I want to comment on the personal tax cuts that you enacted last summer. The personal tax cuts of 23 percent are essentially just enough to prevent bracket creep in 1981 through 1984 from raising the share of income paid in personal taxes. I think therefore those tax cuts should not be eliminated. I do think it would be good, however, to stretch out the 10-percent tax cut scheduled for July 1983 into 5-percent cuts in 1984 and in 1985. That would achieve the same ultimate tax rates but would do so in a way that reduces the deficits in 1983 through 1985 while the spending reductions are being made.

I would not go along with Paul Samuelson and make that an indefinite postponement. I think it is important that the postponement be clear and unambiguous while keeping the total unchanged. I would not want to see Congress back away from the very important thing that it did when it indexed tax brackets after 1985.

The suggestions that I have outlined in my statement add up to a balanced budget in 5 or 6 years with substantially reduced deficits along the way. The basic arithmetic is the 1982 deficit will be about 3 percent of GNP. The combination of business and personal tax cuts and a 7-percent-a-year real increase in defense spending would raise this to about 6 percent of GNP in 1987. But reducing nondefense outlays from the current 18 percent of GNP to 13 percent of GNP over that 5- or 6-year period would lower the deficit to only about 1 percent of GNP. The changes in tax rules can produce a budget that is predicted to be in balance, and there is a good safety margin for keeping the deficit within 1 percent or so of GNP.

In conclusion, let me stress two things about this strategy. First, it will take 5 or 6 years to achieve a fully balanced budget. Although stretching out the personal tax cut can reduce the extent of the budget deficits along the way, there is no way to reduce Government outlays rapidly enough to balance the budget by 1984 or 1985. The strategy for balancing the budget without raising taxes can only work if Congress is prepared to make a 10- or 12-percent reduction in real nondefense outlays cumulatively over the next 5 or 6 years, about 2 percent a year. There is no other choice but to raise personal taxes, to increase the share of personal taxes over what they were 2 or 3 years ago. But if Congress is prepared to slow the growth of Government spending in this way for the next half dozen years, the basic program of tax reductions, increased investment, and lower inflation can succeed. Thank you.

[The prepared statement follows:]

STATEMENT OF MARTIN FELDSTEIN, PH. D., PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

The combination of the current recession, the high interest rates and the recent budget forecasts make it easy to be too gloomy these days. It is important therefore to remember just how much progress has been made in the past year.

The most tangible achievement has been the substantial reduction in the rate of inflation. During 1979 and 1980, the consumer price index jumped at more than 12 percent a year and many people began to worry that inflation was out of control. In contrast, the 1981 CPI increase was less than 9 percent. The producer price index showed even greater progress, with the rate of increase declining from 12 percent in 1979 and 1980 to 7 percent in 1981. The rate of increase of average hourly earnings declined gradually over the year; while January's wages were 10 percent higher than a year earlier, December's wages were only 8.1 percent higher. Most economists anticipate that the 1982 inflation rate will show a further substantial decline.

The significant progress in reducing inflation can be credited primarily to the relatively tight monetary policy during most of the past two years. Tight money prevented the 1980 recovery from developing into a full expansion and then caused a further downturn in economic activity in the summer of 1981. The tight money policy also raised the value of the dollar relative to other currencies and thereby helped to prevent price rises for oil and other internationally traded goods.

Nobody likes a recession but it appears to be the unavoidable price that has to be paid for bringing down the rate of inflation. Moreover, the rise in unemployment has brought much greater progress in reducing inflation than the skeptics of a tight money policy had anticipated. And now that the upward momentum of inflation has been reversed, further gains in reducing inflation should be possible with less slack in the economy.

The financial market is nevertheless still unsure about the decline in inflation and about the Fed's willingness to keep money growth in the coming years within the bounds of gradually declining target ranges. The abnormally high real interest rates at the present time reflect the financial market's fear that the Fed may accelerate money growth in an effort to expand the economy and raise tax receipts or that the Fed may monetize too much of the government debt in future years in an attempt to prevent real interest rates from rising. If the financial market had greater confidence that the Fed would not be persuaded by Congress or the Administration to depart from the policies that Chairman Volcker has announced, the long-term interest rate would be significantly lower.

In addition to the progress in reducing inflation, the major economic achievement of 1981 was the enactment of new tax rules to encourage increased business investment and a higher rate of personal saving. I believe that the accelerated cost recovery rules and the individual retirement accounts will cause a substantial increase in saving and in business investment in the decade of the 1980s relative to their levels in the 1970s. It is important that Congress not change the law in ways that will weaken these incentives. Moreover, priority should be given to the very low cost reform of increasing the $2000 ceiling on IRAs to keep pace with rising incomes.

The principal problem that now clouds the economic future is the series of vast deficits projected in the Administration's recent budget. Even if these budget targets are achieved, the deficits would average nearly $80 billion a year between 1983 and 1986.

But the deficit outlook is even worse because the Administration's revenue forecasts are likely to prove to be overly optimistic. Their forecasts assume a rate of nominal GNP growth that is not consistent with the Fed's plan for limiting the growth of the money stock. If tight money keeps nominal GNP growth below the Administration's projection by one percent a year, personal tax revenue in 1984 will be $20 billion lower and the deficit will exceed $100 billion. And even this bleak figure assumes that the Administration is successful in achieving all of its requested spending cuts.

Sustained deficits of this magnitude are a serious burden for the economy and result in reduced investment, increased inflation or both. Since a government deficit means increased government borrowing from the public, its automatic effect is to raise the real rate of interest and thereby reduce private borrowing and investment. And if the Fed tries to prevent this by purchasing some of the additional government debt, the resulting increase in the money supply would raise the rate of inflation.

While a consistent monetary policy can prevent such inflation, the result would be a substantial crowding out of private investment. Net private investment in the United States is now only about six percent of GNP. A $100 billion deficit in 1984

would imply that the government must borrow two and a half percent of GNP. Since the resulting higher real interest rates would induce an inflow of foreign capital, the government borrowing would not displace an equal amount of private investment. Nevertheless, the impact of a $100 billion deficit on private capital formation is likely to be very significant.

The large deficits are, however, unlikely to cause the financial chaos and extremely high interest rates that some dour Wall Streeters are predicting. Much of that pessimism reflects a confusion between nominal market interest rates and inflation-adjusted real interest rates. The principal reason for hight market interest rates is the fear of inflation. If the Fed follows a policy of consistent monetary control, the inflation premium should fall even though there are larger deficits. The direct effect of the deficit is to raise the real interest rate to a level that reduces private spending here and abroad by enough to finance the government borrowing. Since the inflation premium may fall at the same time that the real rate of interest is rising, there is no reason why large deficits should produce higher market interest rates in the future.

How much higher would real interest rates have to be in 1984 if the government deficit that year is $100 billion instead of $50 billion? Although economists don't know enough to give a precise estimate, a reasonable answer is "not much, probably not more than one or at most two percentage points." The rise in the interest rate is limited to the extent that funds are attracted from abroad by a higher U.S. real interest rate. The interest rate increase is also small if domestic borrowers believe that the large deficits are only temporary and therefore that their cost of funds can be reduced by postponing their borrowing. With some $450 billion of annual investment in the United States and more than that in the rest of the world, a temporary increase in government borrowing by $50 billion is likely to have only a negligible effect on the real rate of interest.

Another source of exaggerated pessimism is the concern that large deficits will "abort the recovery." It is, of course, true that a larger deficit, by raising the real interest rate, will reduce spending for plant and equipment, new housing and consumer durables. However, a large deficit also means either more government spending or lower taxes and therefore more consumer spending, thus providing a direct addition to demand that can stimulate and sustain the recovery.

The real problem is that substantial deficits could eliminate a significant portion of net capital formation. This adverse effect on capital formation, which could occur even if the rise in the real interest rate is small, is the important reason to reduce the projected deficits for the next few years and to bring the budget into balance within five or six years. I believe moreover that such a policy can be designed without rescinding the business or personal tax reductions enacted in 1981.

SLOWER GROWTH OF SPENDING

The key to balancing the budget is to slow the growth of Federal nondefense spending until these outlays equal the 13 percent share of GNP that they did in 1970. During the past two decades, the automatic growth of tax revenue induced Congress to vote for new programs and for program expansions that would never be enacted today. Although these programs are generally not without some value, there is an increasing belief that their value is not enough to warrant the high marginal tax rates that would be necessary to finance them in the future.

Returning nondefense spending to 1970's 13 percent share of GNP over the next six years would only require a 12 percent decline in the real level of nondefense outlays, back to the real level that prevailed as recently as 1978. The combination of a two percent a year reduction in real nondefense outlays and a 3.5 percent real GNP growth would be sufficient to bring nondefense spending back to 13 percent of GNP in six years.

A two percent annual reduction in real nondefense outlays can be achieved most fairly and with the least disruption by making changes in the full range of government programs. Unfortunately, the Administration has refused to make any significant changes in the Social Security retirement, disability and Medicare programs that currently account for some 40 percent of nondefense spending. As a result, the Administration has been forced to propose many spending cuts that are unlikely to be enacted, thereby further increasing the probable deficit in future years.

It is now up to Congress to broaden the range of spending reductions, not in order to cut spending by more than the Administration proposed but to distribute the spending cuts in a way that is both fairer and more likely to achieve legislative approval. Changing the Social Security indexing rule to raise benefits only for price increases in excess of 2 percent would save nearly $20 billion in 1986, or about one-

tenth of the total required spending reduction. Postponing the age at which full retirement benefits are payable and changing the benefit formula for new retirees could also achieve substantial savings without causing painful adjustments for any individual. Returning to an earlier standard of eligibility for disability benefits could save half or more of the current $18 billion outlay. And requiring Medicare patients to pay a modest share of their hospital charges in the same way that patients with private insurance do would not only reduce the $45 billion Medicare outlay but would also help to control the inflation in hospital costs. All of these changes could be done in a way that exempts those who are truly poor without significantly affecting the revenue savings.

What about defense spending? In dollars of constant purchasing power, the United States spent less on defense in 1980 than it did in 1960. As a fraction of GNP, defense spending halved from 10.0 percent of GNP in 1960 to less than five percent in 1980. As an economist I do not know what fraction of GNP would be spent on defense. That clearly depends on the efforts being made by our enemies and allies as well as on the technological possibilities for translating more spending into greater deterrence.

The Administration originally proposed raising real defense spending at seven percent a year, a rate that would raise the defense share of GNP by one percentage point in four years and that would double real defense spending in a decade. The revised budget calls for nearly nine percent real growth of defense outlays between 1981 and 1985. Without judging whether such an increase is warranted by military conditions, I will only note that returning to seven percent real defense growth would reduce defense outlays by $20, billion in 1985.

REVENUE CHANGES

Turning to the revenue side, there is much that can be done without revoking the personal and business tax cuts or tampering with the 1985 indexing rule. Rapid decontrol of natural gas prices would conserve this important resource and add $15 to $20 billion a year to tax receipts.

There are several revenue producing changes in tax rules that would deserve to be made even if there were not a deficit. High on my list is limiting the exclusion of employer contribution for medical insurance premiums, a rule that is responsible for much of the inflation of health care costs and that now reduces income tax revenue by more than $15 billion and payroll tax revenue by additional billions. Other tax rules that not only reduce revenue but also distort economic incentives are the exclusion of unemployment benefits (with an estimated revenue loss of more than $5 billion) and of workmen's compensation benefits ($3 billion) and the deduction of consumer interest ($6 billion). The combination of natural gas decontrol and efficiency-improving tax changes could easily add $30 billion a year to revenue in 1984 and beyond.

The personal tax cuts of 23 percent are essentially just enough to prevent bracket creep in 1981 through 1984 from raising the share of income paid in taxes. It would be good, however, to stretch out the 10 percent tax cut scheduled for July 1983 into 5 percent cuts in July 1984 and July 1985. That would achieve the same ultimate tax rates but would do so in a way that reduces the deficits in 1983 through 1985 while the spending reductions are being made. The extra revenues would be about $35 billion in fiscal 1984 and nearly $20 billion in fiscal 1985.

ADDING IT UP

How does it all add up? The 1982 deficit will be about three percent of GNP. The combination of the business and personal tax cuts and a seven percent real annual increase in defense spending would raise this to about six percent of GNP in 1987. Reducing nondefense outlays from 18 percent of GNP in 1982 to 13 percent would lower the deficit to about one percent of GNP. The changes in tax rules can produce a budget that is predicted to be in balance and that has a good safety margin for keeping the deficit within one percent of GNP.

Two things about this strategy are obvious. First, it will take five or six years to achieve a balance budget. Although stretching out the personal tax cut can reduce the extent of the budget deficits along the way, there is no way to reduce government outlays rapidly enough to balance the budget by 1984 or 1985. Second, the strategy for balancing the budget without raising taxes can only work if Congress is prepared to make a 10 to 12 percent reduction in real nondefense outlays over the next five or six years. If such spending cuts will not be made, there is no choice but to raise personal taxes. But if Congress is prepared to slow the growth of govern-

ment spending in this way for the next half dozen years, the basic program of tax reductions, increased investment and lower inflation can succeed.

Chairman ROSTENKOWSKI. Dr. Stein, I know that I made a commitment to have you on your way by 3 o'clock. Would you like to make additional observations before you leave?

Mr. STEIN. I do feel very much in agreement with three-quarters of my colleagues, and I feel I leave you in good hands when I go. I would like, since I have a minute, to say something about what seems to me a very dangerous trend of thinking in the Congress and in the city at this time, and that is that the solution of our fiscal problem should be achieved in part by cutting the projected defense program. The defense program has no constituency except posterity, and it is politically attractive to cut. There is a ridiculous notion that fairness to the people who receive food stamps requires that we should reduce the defense of the Nation. You have no riskless course before you, but among the risks that you have to take, the one that should certainly be avoided is the risk of leaving the country less adequately defended than it ought to be. I hope that this temptation will be resisted. It is easy to say that there is a lot of fat in the defense program, and it can always be cut, but there are many knowledgeable people and people who are devoted to the security of the country who think that a program of this size that the administration has proposed is absolutely essential, even though perhaps not in exactly the form it is proposed, and I think it would be very dangerous to tinker with this as a way of solving our fiscal problems.

Chairman ROSTENKOWSKI. Are you saying there would be no defense cuts?

Mr. STEIN. I would say no defense cuts, absolutely. If I ask myself would I rather cut the defense budget by $10 billion or propose a 10-cent gasoline tax or do any of the other $10 billion things that Mr. Pechman outlined, it seems to me crystal clear that we are better off to take that $10 billion out of the $2 trillion of personal consumption in the United States than to take it out of the $200 billion of national defense. This country is not suffering from an inadequacy of personal consumption, but of a weakness of its national defense, and that needs to be rectified.

Chairman ROSTENKOWSKI. I listened with great interest to the "profile-in-courage" approach that Joe Pechman suggested to us. This is an even-numbered year. I do not see too many people enthusiastic about raising taxes, particularly in the areas suggested by Dr. Pechman. There are rumors from the other body that the defense budget is not a sacred cow. People more knowledgeable than I in the defense area are talking about cutting some defense appropriations.

Congressman Downey would like to ask a question.

Mr. DOWNEY. Mr. Chairman, I would not want Dr. Stein to go back to Virginia fearing that there was not a constituency for defense increases or spending. I suggest you appear before the House Armed Services Committee, and I will show you 44 Members of Congress who are ardent constituents of defense spending, as well as anyone with a military base or who wants to appear before an American Legion group. I think it has a stronger constituency than any social program that has ever been before the Congress.

Mr. STEIN. I would say that this committee puts a constraint around the activities of the Armed Services appropriations committees. They operate within the limits of the funds that you make available, and I hope you will not make the noose too tight.

Mr. Chairman, you have a historic opportunity. You can be the first Ways and Means Committee since 1935 that raised tax rates in peacetime, except for social security taxes.

Chairman ROSTENKOWSKI. Thank you, Dr. Stein. At this point, I would like for the panel members to engage in a free discussion. Then, I will recognize members of the committee to ask questions.

Dr. Pechman, would you like to make some observations?

Mr. PECHMAN. Martin Feldstein and Craig Roberts both talked about the fact that the 1981 tax cuts really were not tax cuts, that the bracket creep offset much or most of the cuts that you made last year. I would like to summarize for you a paper prepared by a young colleague of mine on the distributional effects of the 1981 act. In this paper, which I hope you will put in the record, he estimates the effect of what inflation would have had on the increase in effective rates, and shows what the new act does in 1982, 1983, and 1984. It is true that a significant percentage of the tax cut would simply offset the expected inflation, but not all of it by any means. Of the $116 billion of estimated tax cut in 1984 from the previous rates, $41 billion would be over and above the inflation. So that more than 40 percent—about 40 percent of the tax cut is a real tax cut. Moreover, with respect to its effect on incentives, it is true that for the bottom brackets there will be a real tax increase, because you did not adjust the personal exemptions and the standard deduction. There is a real tax cut above the level of $15,000 to $20,000. This cut goes from 4.5 percent in the $15,000 bracket to 28.6 percent for millionaires. The increase in disposable income resulting from the tax cut begins at a half a percent in the $15,000 bracket and goes to 25 percent for millionaires.

[The following was subsequently received:]

INDIVIDUAL INCOME TAX PROVISIONS OF THE 1981 TAX ACT [1]

(By John Karl Scholz, Brookings Institution)

The Economic Recovery Tax Act of 1981 provided the largest income tax cut in America's history. The Act dramatically reduced tax rates, provided new tax incentives for saving, and added numerous other special deductions. The purpose of this appendix is to provide estimates of the magnitude and distribution of the tax cuts for the years 1982–1984. This is done by comparing the revenues generated under the new law with those that would have been generated under the previous law. The analysis is devoted exclusively to the individual income tax provisions of the Act.

The data for this analysis are from an income tax file developed by the Internal Revenue Service, which contains all the tax information from a random stratified sample of 155,212 tax returns filed for the year 1977. The file was projected to later years on the basis of published tax return data for 1979 and changes in income assumed in the budget for fiscal 1982 and later years. The calculations were made on a computer by a tax calculator, developed by the Brookings Tax Project, which reads information from tax returns and computes adjusted gross income, taxable income, and taxes after credits. The provisions of the 1981 Tax Act were incorporated into the tax calculator software on the basis of several assumptions which are described in detail in the notes to this appendix.

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[1] Prepared for "Setting National Priorities: The 1983 Budget" (Brookings Institution, forthcoming).

AGGREGATE ESTIMATES

Estimates of total income tax liabilities under the old and new tax laws for calendar years 1982–1984 are given in table A–1. The tax cut amounts to an estimated $41.5 billion in 1982, $85.8 billion in 1983, and $116.3 billion in 1984 or, as a percentage of the total income tax liability under the 1980 law, 12.7 percent in 1982, 22.0 percent in 1983, and 26.1 percent in 1984. However, a signficant portion of this tax cut merely offsets the effect of the creep upward in the tax brackets as a result of inflation. When compared with what tax liabilities would have been under the 1980 tax law adjusted for inflation, the tax cuts average only 2.6 percent in 1982, 9.2 percent in 1983, and 11.0 percent in 1984. In other words, about 80 percent of the 1982 cut and over 50 percent of the 1983 and 1984 cuts offset the increase in effective tax rates that would have occurred because of the continuation of inflation during this period.

Table A–2 compares the effective tax rates under the 1982, 1983 and 1984 laws with the effective rates generated by the 1980 law projected to those years. The returns are classified by their adjusted gross income under the 1980 law. Effective tax rates under the old and new laws were calculated by dividing taxes after credits by adjusted gross income.

TABLE A–1.—TOTAL ADJUSTED GROSS INCOME AND TOTAL INCOME TAX LIABILITIES UNDER THE ECONOMIC RECOVERY TAX ACT OF 1981 AND UNDER THE 1980 LAW, 1982–84

[Dollar amounts in billions]

Year	Adjusted gross income [1]	Tax liabilities		Reduction in tax liabilities		
		1980 law	1981 law	Amount	Percent of AGI	Percent of tax under 1980 law
	1981 law compared with the 1980 law					
1982	$1,968	$325	$284	$41	2.1	12.7
1983	2,227	390	305	85	3.9	22.0
1984	2,432	446	330	116	4.8	26.1
	1981 law compared with the indexed 1980 law					
1982	1,968	291	284	8	0.4	2.6
1983	2,227	335	305	31	1.4	9.2
1984	2,432	371	330	41	1.7	11.0

[1] As defined in the 1980 law.

Source: Calculations based on the 1977 income tax file projected to 1982–84. Figures are rounded.

TABLE A–2.—INDIVIDUAL INCOME TAX LIABILITIES UNDER THE ECONOMIC RECOVERY TAX ACT OF 1981 COMPARED WITH THE 1980 LAW, 1982–84

[In percent]

Adjusted gross income class [1]	Effective tax rates		Tax reduction as percent of—		
	1980 law	1981 law	Tax	Adjusted gross income before tax	Adjusted gross income after tax
1982:					
0 to $5,000	1.2	1.1	10.7	0.1	0.1
$5,000 to $10,000	6.5	5.8	11.4	0.7	0.8
$10,000 to $15,000	10.0	8.9	11.2	1.1	1.2
$15,000 to $20,000	12.3	10.9	11.2	1.4	1.6
$20,000 to $25,000	13.5	11.9	11.5	1.5	1.8
$25,000 to $50,000	15.8	13.8	12.4	1.9	2.3
$50,000 to $100,000	23.4	20.3	13.3	3.1	4.1
$100,000 to $200,000	33.3	28.9	13.2	4.4	6.6
$200,000 to $500,000	40.8	34.4	15.8	6.4	10.9
$500,000 to $1,000,000	44.6	36.9	19.2	8.6	15.5

TABLE A–2.—INDIVIDUAL INCOME TAX LIABILITIES UNDER THE ECONOMIC RECOVERY TAX ACT OF 1981 COMPARED WITH THE 1980 LAW, 1982–84—Continued

[In percent]

Adjusted gross income class [1]	Effective tax rates		Tax reduction as percent of—		
	1980 law	1981 law	Tax	Adjusted gross income before tax	Adjusted gross income after tax
$1,000,000 and over	47.3	36.9	22.0	10.4	19.7
All classes [2]	16.5	14.4	12.7	2.1	2.5
1983:					
0 to $5,000	1.2	1.0	21.8	0.3	0.3
$5,000 to $10,000	6.8	5.4	20.5	1.4	1.5
$10,000 to $15,000	10.2	8.1	20.6	2.1	2.4
$15,000 to $20,000	12.5	9.9	20.8	2.6	3.0
$20,000 to $25,000	14.0	11.0	21.4	3.0	3.5
$25,000 to $50,000	16.1	12.4	22.9	3.7	4.4
$50,000 to $100,000	23.5	18.1	22.8	5.4	7.0
$100,000 to $200,000	33.4	26.5	20.5	6.8	10.3
$200,000 to $500,000	40.8	33.2	18.8	7.7	13.0
$500,000 to $1,000,000	44.8	35.8	20.0	9.0	16.2
$1,000,000 and over	47.3	36.8	22.2	10.5	19.9
All classes [2]	17.5	13.7	22.0	3.9	4.7
1984:					
0 to $5,000	1.3	1.0	25.3	0.3	0.3
$5,000 to $10,000	6.9	5.3	24.1	1.7	1.8
$10,000 to $15,000	10.5	7.9	24.4	2.6	2.9
$15,000 to $20,000	12.8	9.6	24.9	3.2	3.6
$20,000 to $25,000	14.3	10.6	25.5	3.6	4.2
$25,000 to $50,000	16.4	12.0	26.6	4.3	5.2
$50,000 to $100,000	23.4	17.3	26.0	6.1	8.0
$100,000 to $200,000	33.7	24.3	27.1	9.0	13.6
$200,000 to $500,000	40.8	30.9	24.3	9.9	16.8
$500,000 to $1,000,000	44.9	33.4	25.8	11.6	21.0
$1,000,000 and over	47.2	33.5	29.1	13.8	26.1
All classes [2]	18.3	13.6	26.1	4.8	5.9

[1] As defined in the 1980 law.
[2] Includes negative adjusted gross income.

Source: Calculations based on the 1977 income tax file projected to 1982–84. Figures are rounded.

The Economic Recovery Tax Act of 1981 was billed as an "across-the-board" tax cut—an Act that reduces taxes uniformly for all income classes. As table A–2 illustrates, this is roughly the case. The tax reduction for 1984, which averages 26.1 percent, varies between 24 and 27 percent for all income classes except the $1,000,000 and over class where the tax reduction averages 29 percent. The rise in the top brackets is attributable to the cut in the top bracket rate on unearned income from 70 percent to 50 percent, the reduction in the top capital gains rate from 28 percent to 20 percent, and new saving provisions, the benefits of which will be concentrated in the top part of the income distribution.

One consequence of a uniform tax cut is that the change in disposable income is not uniform. Given a progressive tax system, a 25 percent cut in taxes has a much different effect on the disposable income of a person paying $15,000 in taxes than on a person paying $150 in taxes. This is illustrated by the last column of Table A–2. In 1984, the change in disposable income resulting from the tax cut increases steadily from a low of 0.3 percent for those receiving less than $5,000 to a high of 26 percent for those with incomes of more than $1 million.

A great deal of the debate before the 1981 tax cuts were enacted was concerned with whether the new tax law would reduce tax liabilities enough to offset the tax-raising effect of inflation as a result of "bracket creep". In table A–3, the taxes to be paid in 1982–1984 are compared with the tax that would have been paid had the

1980 law been indexed. To obtain the indexed 1980 law, the personal exemptions were raised, the zero bracket amount was increased and the rate tables were adjusted by the projected inflation rates.

As shown in table A–3, the tax cuts for the lower income classes (those earning below $15,000 adjusted gross income) will not compensate for the effect of inflation. For those earning more than $15,000 a year, there is a "real" reduction in the percentage change in effective rates. For 1984, these reductions increase from 4.3 percent at $15,000 to 28.6 percent in the highest income class.

DETAILED ESTIMATES OF INDIVIDUAL PROVISIONS

Table A–4 presents detailed estimates of the tax reductions resulting from the major provisions of the 1981 act by income classes for 1982, 1983 and 1984.

Rate cuts

The cornerstone of the Economic Recovery Tax Act of 1981 is a set of cumulative across-the-board rate reductions of 10 percent in 1982, 19 percent in 1983, and 23 percent in 1984. These rate changes are by far the most significant reductions of the 1981 act. As shown in table A–4, revenues will be reduced by an estimated $104.8 billion in 1984 as a consequence of the rate reductions. As is suggested by the term "across-the-board", all income classes will get substantial reductions in tax liability.

Table A–3.—INDIVIDUAL INCOME TAX REDUCTIONS UNDER THE ECONOMIC RECOVERY TAX ACT OF 1981 COMPARED WITH THE 1980 LAW INDEXED FOR INFLATION 1982–84

[In percent]

Adjusted gross income class [1]	Effective tax rates		Tax reduction as percent of		
	1980 law indexed	1981 law	Tax	Adjusted gross income before tax	Adjusted gross income after tax
1982:					
$0 to $5,000	0.5	1.1	[3] −112.3	[3] −0.6	[3] −0.6
$5,000 to $10,000	5.0	5.8	[3] −15.3	[3] −.8	[3] −.8
$10,000 to $15,000	8.4	8.8	[3] −4.9	[3] −.4	[3] −.4
$15,000 to $20,000	10.7	10.9	[3] −1.5	[3] −.2	[3] −.2
$20,000 to $25,000	12.0	11.9	1.0	0.1	0.1
$25,000 to $50,000	14.1	13.8	1.9	0.3	0.3
$50,000 to $100,000	20.9	20.3	2.9	0.6	0.8
$100,000 to $200,000	31.2	28.9	7.3	2.3	3.3
$200,000 to $500,000	39.4	34.3	12.9	5.1	8.4
$500,000 to $1,000,000	44.1	36.0	18.2	8.0	14.3
$1,000,000 and over	47.1	36.9	21.6	10.2	19.3
All classes [2]	14.8	14.4	2.6	0.4	0.5
1983:					
$0 to $5,000	0.3	1.0	[3] −203.9	[3] −0.7	[3] −0.7
$5,000 to $10,000	4.6	5.4	[3] −16.5	[3] −.8	[3] −.8
$10,000 to $15,000	8.1	8.1	[3] −.6	[3] −.1	[3] −.1
$15,000 to $20,000	10.3	9.9	3.9	.4	.4
$20,000 to $25,000	11.9	11.0	7.9	.9	1.1
$25,000 to $50,000	13.8	12.4	9.9	1.4	1.6
$50,000 to $100,000	19.9	18.1	9.1	1.8	2.3
$100,000 to $200,000	30.3	26.5	12.5	3.8	5.4
$200,000 to $500,000	38.9	33.2	14.7	5.7	9.4
$500,000 to $1,000,000	43.9	35.8	18.5	8.1	14.5
$1,000,000 and over	47.0	36.8	21.7	10.2	19.3
All classes [2]	15.1	13.7	9.2	1.4	1.6
1984:					
$0 to $5,000	0.2	1.0	[3] −392.1	[3] −0.8	[3] −0.8
$5,000 to $10,000	4.3	5.3	[3] −23.8	[3] −1.0	[3] −1.1
$10,000 to $15,000	7.8	7.9	[3] −2.0	[3] −.2	[3] −.2
$15,000 to $20,000	10.0	9.6	4.3	.4	.5
$20,000 to $25,000	11.7	10.6	9.0	1.1	1.2

Table A–3.—INDIVIDUAL INCOME TAX REDUCTIONS UNDER THE ECONOMIC RECOVERY TAX ACT OF 1981 COMPARED WITH THE 1980 LAW INDEXED FOR INFLATION 1982–84—Continued

[In percent]

Adjusted gross income class [1]	Effective tax rates		Tax reduction as percent of		
	1980 law indexed	1981 law	Tax	Adjusted gross income before tax	Adjusted gross income after tax
$25,000 to $50,000	13.6	12.0	11.5	1.6	1.8
$50,000 to $100,000	19.1	17.3	9.1	1.7	2.2
$100,000 to $200,000	29.4	24.3	17.4	5.1	7.3
$200,000 to $500,000	38.3	30.9	19.4	7.5	12.1
$500,000 to $1,900,000	43.8	33.4	23.9	10.5	18.6
$1,000,000 and over	46.8	33.5	28.6	13.4	25.2
All classes [2]	15.2	13.6	11.0	1.7	2.0

[1] As defined in the 1980 law.
[2] Includes negative adjusted gross income.
[3] Minus sign indicates tax increase.

Source: Calculations based on the 1977 income tax file projected to 1982–84. Figures are rounded.

TABLE A–4.—INCOME TAX REDUCTIONS RESULTING FROM THE MAJOR PROVISIONS OF THE ECONOMIC RECOVERY TAX ACT OF 1981, 1982–84

[Dollar amounts in millions]

Adjusted gross income [1]	Tax reductions resulting from—							
	Rate cuts		Two-earner deduction		Savings incentives [3]		Charity and child care credit	
	Amount	Percent [2]	Amount	Percent [2]	Amount	Percent [2]	Amount	Percent [2]
1982:								
$0 to $5,000	$173.9	0.2	(*)	(*)	$−24.3	−0.1	$9.3	(*)
$5,000 to $10,000	953.2	.8	$10.1	(*)	−132.6	−.1	42.9	(*)
$10,000 to $15,000	1,950.1	1.1	60.2	(*)	−179.7	−.1	67.5	(*)
$15,000 to $20,000	2,621.8	1.4	146.3	0.1	−168.8	−.1	63.0	(*)
$20,000 to $25,000	3,099.6	1.4	278.5	.1	−69.7	(*)	46.5	(*)
$25,000 to $50,000	13,208.7	1.6	2,191.7	.3	408.7	.1	51.5	(*)
$50,000 to $100,000	6,523.7	2.3	624.8	.2	1,529.3	.5	7.8	(*)
$100,000 to $200,000	3,151.7	3.6	143.5	.2	572.3	.7	1.0	(*)
$200,000 to $500,000	2,339.3	6.0	35.2	.1	141.7	.4	.1	(*)
$500,000 to $1,000,000	773.0	8.4	3.1	(*)	13.4	.1	(*)	(*)
$1,000,000 and over	897.9	10.3	.7	(*)	3.7	(*)	(*)	(*)
All classes [4]	35,592.8	1.8	3,494.2	.2	2,093.7	.1	289.7	(*)
1983:								
$0 to $5,000	105.4	.2	(*)	(*)	.8	(*)	8.0	(*)
$5,000 to $10,000	1,451.2	1.3	16.9	(*)	43.8	(*)	36.7	(*)
$10,000 to $15,000	3,267.0	2.0	96.5	.1	61.0	(*)	59.8	(*)
$15,000 to $20,000	4,569.3	2.4	228.0	.1	73.2	(*)	61.9	(*)
$20,000 to $25,000	5,738.6	2.7	436.3	.2	146.2	.1	42.6	(*)
$25,000 to $50,000	28,786.5	3.1	4,437.4	.5	1,379.8	.1	69.0	(*)
$50,000 to $100,000	17,095.1	4.4	1,585.3	.4	2,204.9	.6	11.6	(*)
$100,000 to $200,000	6,583.4	5.9	358.8	.3	759.5	.7	1.6	(*)
$200,000 to $500,000	3,587.4	7.1	89.6	.2	200.4	.4	.2	(*)
$500,000 to $1,000,000	1,032.6	8.7	8.2	.1	18.7	.2	(*)	(*)
$1,000,000 and over	1,118.7	10.4	2.0	(*)	4.7	(*)	(*)	(*)
All classes [4]	73,335.1	3.3	7,259.1	.3	4,892.9	.2	291.4	(*)
1984:								
$0 to $5,000	108.5	.3	(*)	(*)	.1	(*)	22.8	0.1
$5,000 to $10,000	1,647.5	1.6	13.3	(*)	17.8	(*)	85.8	.1

TABLE A–4.—INCOME TAX REDUCTIONS RESULTING FROM THE MAJOR PROVISIONS OF THE ECONOMIC RECOVERY TAX ACT OF 1981, 1982–84—Continued

[Dollar amounts in millions]

Adjusted gross income [1]	Tax reductions resulting from—							
	Rate cuts		Two-earner deduction		Savings incentives [3]		Charity and child care credit	
	Amount	Percent [2]	Amount	Percent [2]	Amount	Percent [2]	Amount	Percent [2]
$10,000 to $15,000	3,929.1	2.4	77.8	(*)	42.8	(*)	117.5	.1
$15,000 to $20,000	5,602.7	3.0	189.5	.1	54.5	(*)	119.1	.1
$20,000 to $25,000	6,938.7	3.4	388.0	.2	96.5	(*)	86.4	(*)
$25,000 to $50,000	38,554.5	3.8	4,415.5	.4	915.1	.1	174.9	(*)
$50,000 to $100,000	27,438.3	5.4	1,939.8	.4	1,411.4	.3	31.1	(*)
$100,000 to $200,000	11,353.6	8.3	421.9	.3	544.1	.4	2.6	(*)
$200,000 to $500,000	5,859.6	9.5	107.6	.2	157.9	.3	.3	(*)
$500,000 to $1,000,000	1,644.5	11.4	10.4	.1	14.3	.1	(*)	(*)
$1,000,000 and over	1,738.4	13.7	2.3	(*)	3.4	(*)	(*)	(*)
All classes [4]	104,815.4	4.3	7,566.0	.3	3,257.8	.1	640.4	(*)

[1] As defined in the 1980 law.
[2] Percentage of adjusted gross income.
[3] Savings incentives include IRAs, all savers, Keoghs and interest and dividend exclusions, negatives indicate tax increases.
[4] Includes negative adjusted gross income.

Source: Calculations based on the 1977 income tax file projected to 1982–84. Figures are rounded. Asterisks indicate values less than 0.05.

Savings incentives

A stated objective of the 1981 Tax Act was to provide incentives for people to increase their savings. In addition to rate cuts, these incentives take three forms. The provisions for Individual Retirement Accounts (IRAs) and self-employed pension plans (Keoghs) were liberalized, and interest from certain specific savings certificates (all savers) was excluded from taxation.

Four major changes were made in the law with respect to the Individual Retirement Account. The deductible contribution by an employed person to an IRA was increased from $1,500 to $2,000 and, in the case of spousal IRAs, from $1,750 to $2,250. In addition an individual who is already participating in a qualified employer retirement plan will be allowed to establish an IRA.

As shown in table A–5, the estimated revenue loss from IRA deductions is $2.9 billion in 1984. Though taxpayers in all income classes will benefit from the new IRAs, the greatest effect will be in the $50,000 to $100,000 income class. This income class accounts for 45.5 percent of the $2.9 billion estimated reduction in tax revenues from the changes in the IRA provisions.

The 1981 law increased the maximum contribution to "Keogh" plans established by self-employed persons from $7,500 to $15,000. This provision, which will reduce tax revenues by $360 million in 1984 (see table A–5), will have virtually no impact on those with adjusted gross incomes of less than $50,000: most of the benefit will go to those with adjusted gross income of more than $100,000.

TABLE A–5.—INCOME TAX REDUCTIONS RESULTING FROM THE SAVINGS INCENTIVES OF THE ECONOMIC RECOVERY TAX ACT OF 1981, 1982–84

[In millions of dollars]

Adjusted gross income [1]	IRA's	Keogh's	All saver certificates	Interest and dividend exclusion [2]
1982:				
$0 to $5,000	0.3	0	2.3	−27.0
$5,000 to $10,000	22.5	0	22.1	−177.3
$10,000 to $15,000	41.6	0	25.4	−246.7
$15,000 to $20,000	65.3	0	28.2	−262.3
$20,000 to $25,000	169.4	0	51.2	−290.3
$25,000 to $50,000	964.0	.8	744.7	−1,300.8

TABLE A–5.—INCOME TAX REDUCTIONS RESULTING FROM THE SAVINGS INCENTIVES OF THE ECONOMIC RECOVERY TAX ACT OF 1981, 1982–84—Continued

[In millions of dollars]

Adjusted gross income [1]	IRA's	Keogh's	All saver certificates	Interest and dividend exclusion [2]
$50,000 to$ 100,000	949.4	93.6	1,077.1	−590.7
100,000 to $200,000	252.1	111.6	325.7	−117.1
$200,000 to $500,000	59.2	26.8	79.5	−23.8
$500,000 to $1,000,000	5.7	2.1	7.7	−2.1
$1,000,000 and over	1.6	.5	2.1	−.6
All classes [3]	2,531.3	235.4	2,366.1	3,039.1
1983:				
$0 to $5,000	0	0	.8	0
$5,000 to $10,000	21.3	0	22.5	0
$10,000 to $15,000	27.5	0	33.5	0
$15,000 to $20,000	39.0	0	34.2	0
$20,000 to $25,000	113.5	0	32.8	0
$25,000 to $50,000	978.2	.9	400.7	0
$50,000 to $100,000	1,132.1	97.6	975.2	0
$100,000 to $200,000	302.0	163.5	294.0	0
$200,000 to $500,000	77.0	45.9	77.5	0
$500,000 to $1,000,000	7.6	3.6	7.5	0
$1,000,000 and over	2.1	.8	1.8	0
All classes [3]	2,700.2	312.2	1,880.5	0
1984:				
$0 to $5,000	.1	0	0	0
$5,000 to $10,000	17.8	0	0	0
$10,000 to $15,000	42.8	0	0	0
$15,000 to $20,000	54.5	0	0	0
$20,000 to $25,000	96.5	0	0	0
$25,000 to $50,000	914.5	.6	0	0
$50,000 to $100,000	1,320.9	90.5	0	0
$100,000 to $200,000	345.3	198.9	0	0
$200,000 to $500,000	94.3	63.8	0	0
$500,000 to $1,000,000	9.3	4.9	0	0
$1,000,000 and over	2.3	1.0	0	0
All classes [3]	2,898.0	359.7	0	0

[1] As defined in the 1980 law.
[2] Minus sign indicates tax increases.
[3] Includes negative adjusted gross income.

Source: Calculations based on the 1977 income tax file projected to 1982–84. Figures are rounded.

The all savers provision allows an individual a once-in-a-lifetime exclusion of up to $1,000 ($2,000 on joint returns) for interest earned on an investment in a special qualified savings certificate issued by saving and loan associations, banks, and credit unions in the period October 1, 1981 to December 31, 1982. In 1982, $2.37 billion in revenue will be lost as a consequence of the All Savers legislation. As with the new IRA provisions, the All Savers legislation will reduce tax liabilities in all income classes, but 54 percent of the benefit will go to those with adjusted gross income between $50,000 and $200,000.

To recover some of the revenue lost from the new savings provisions, the $200 exclusion for interest and dividend income ($400 on joint returns), which applied only to the years 1981 and 1982, was repealed for 1982. This repeal, which reinstates the $100 dividend exclusion ($200 on joint returns), will increase tax revenues $3 billion in 1982. In 1985 and subsequent years, individuals will be allowed to deduct 15 percent of net interest up to $3,000 ($6,000 on joint returns). This new provision will reduce revenues $1.9 billion in 1985.

Child care credit, charitable contributions deduction

Two provisions of the Economic Recovery Tax Act of 1981 affected those in lower income classes proportionately more than those in upper income classes. These provisions allow non-itemizers to deduct a portion of their charitable contributions and will allow lower and moderate income people to take a larger child and dependent care credit. As shown in table A-4, these two provisions reduce tax revenues by $640 million in 1984.

Deduction for two-earner couples

The last major provision of the 1981 act is the deduction for two-earner married couples, which was intended to moderate the so-called marriage penalty resulting from the income splitting provision and the special rate schedule for single persons. The deduction will be 5 percent of the earned income of the spouse with lower earnings (up to $30,000) in 1982 and 10 percent in 1983 and later years.

The deduction for two-earner couples will reduce total tax revenues by $7.6 billion in 1984 (see Table A-4). The major beneficiaries of this deduction are married couples reporting adjusted gross income between $25,000 and $50,000, who will receive 58.4 percent of the benefit from the deduction.

Notes

The most important assumptions made in developing the estimates for this appendix are as follows:

Deduction for two-earner married couples.—To eliminate the so-called "marriage penalty", which results from the use of different tax schedules for single, head of household and married taxpayers, the 1981 act allows a married couple with two earners to deduct five percent of the earned income of the spouse with the lower earnings (up to $30,000) in 1982 and ten percent in 1983 and subsequent years. The income tax file does not contain information on the distribution of income reported on joint returns. To estimate the income of each spouse, use was made of a Treasury Department matrix that gives, for each income class, a distribution of the earnings of spouses in two-earner couples.

Charitable contributions deductions for nonitemizers.—Data on the contributions of nonitemizers are not available. It was assumed that nonitemizers are split into four groups of equal size which give 100, 75, 50 or 25 percent of the maximum contribution ($100 in 1982, 1983; $300 in 1984). As provided in the 1981 act, 25 percent of these amounts were allowed as deductions. (The allowable deduction is increased to 50 percent of contributions up to $300 in 1985 and 100 percent of contributions in 1986 and later years). If it were assumed that all nonitemizers would give the maximum amount each year, the annual revenue loss from the charitable contributions provision would increase about 60 percent.

Child and dependent care credit.—The 1981 act increases outlays eligible for the credit from $2,000 to $2,400 for each of the first two dependents for all taxpayers and raises the rates of the credit from 20 percent to 30 percent for taxpayers with income of $10,000 or less, with a phase-out of the credit between $10,000 and $28,000. The increased credit was calculated directly from the amounts reported in the tax file.

Individual retirement accounts.—It was assumed that, as incomes rise, the percentage of people participating in IRA plans will rise from 0 percent for those reporting less than $5,000 annual adjusted gross income to 40 percent of those reporting more than $50,000. For each participant the size of the IRA contribution was obtained from the following formula:

IRA = 5 (Dividend income + Interest income − All Savers) − 100 This formula assumes the participants will transfer assets to IRAs when interest and dividend income from those assets exceeds $100. The factor of five reflects both the estimated interest rate and expected utilization of the provision. The limit for any one individual earner was set at the statutory limit of $2,000. For joint returns, the IRA deduction for each spouse was estimated from the Treasury matrix used to calculate the effect of the new deduction for two-earner couples.

If it were assumed that the percentage of people participating in IRA plans ranged from 0 percent for those reporting less than $5,000 to 100 percent for those reporting more than $50,000 and the IRA contributions were increased to IRA = 10(Dividend income + Interest income − All Savers), the revenue loss from the IRA provision would triple.

Self-employed pension plans.—The limit of the deduction for these plans was raised from $7,500 to $15,000.

Tax-exempt savings certificates (all savers).—It was assumed that the pool of purchasers of all savers certificates would be 10 percent of those below the 30 percent

marginal tax bracket and all those above this level. For this pool, the amount of tax-exempt interest was calculated from the following equation:

All Savers = .6(Dividend Income − 200) + .8(Interest Income − 100)

This equation assumes that people will transfer a portion of their interest and dividend bearing assets which yield more than $200 in dividend income and $100 in interest income. To allow for the statutory limit of the interest on all savers certificates to 70 percent of the one-year Treasury bill rates, the reduction in tax liabilities was limited to $2,857 ($2,000 divided by .7). One-eighth of the total deduction for all savers certificates was distributed to 1981, one-half to 1982, and the remaining three-eighths to 1983.

If it were assumed that all people who had sufficient interest and dividend income as defined by the equation

All Savers = (Dividend Income − 200) + (Interest Income − 100) purchased all savers, the revenue loss attributable to the all savers provision would double.

Exclusion for interest and dividends.—The $200 deduction for interest and dividends ($400 on joint returns) was replaced by a dividend deduction of $100 ($200 on joint returns).

Mr. PECHMAN. With respect to the marginal rates, I have a table that I would also like to include in the record that shows what the change in the marginal rates has been at real 1981 income levels, beginning with $15,000 and going up to $250,000. The fact of the matter is that at all brackets above $15,000 there is a reduction in marginal rates, and this is at real-income levels. It is true that the reduction in marginal rates is modest at the bottom; at $15,000 it is a 3-percentage-point reduction; but at $45,000 it is a 5-percentage-point reduction, at $50,000 it is an 11-percentage-point reduction, at $100,000 it is a 10-percentage-point reduction; and at $250,000 it is a 20-percentage-point reduction. It is not true that there is no tax cut. What is true is that the tax cut for the upper middle class and the wealthy is very, very generous indeed.

[The following table was subsequently received:]

MARGINAL TAX RATES, 1981 AND 1984 AT 1981 REAL TAXABLE INCOMES

Taxable income		Marginal rates (percent)		Difference
1981	1984 [1]	1981 [2]	1984 [3]	
$15,000	$18,000	21	18	−3
20,000	24,000	24	22	−2
25,000	30,000	32	28	−4
30,000	36,000	37	33	−4
35,000	42,000	37	33	−4
40,000	48,000	43	38	−5
45,000	54,000	43	38	−5
50,000	60,000	49	38	−11
75,000	90,000	54	45	−9
100,000	120,000	59	49	−10
150,000	180,000	64	50	−14
250,000	300,000	70	50	−20

[1] Taxable income in 1984 is inflated by the income in the gross national product deflator projected in "The Budget of the United States Government, Fiscal Year 1983," pp. 2–5 and 2–6.

[2] Rates under the 1980 law applied to 1981 income.

[3] Rates scheduled for 1984 under the Economic Recovery Tax Act of 1981 applied to 1984 incomes inflated by the gross national product deflator (see footnote a).

Mr. ROBERTS. Mr. Pechman is concerned with distribution in his questions, and the paper he quoted from uses an inappropriate statistical procedure to measure a tax cut. It is not possible for an across-the-board rate reduction to give differential reductions. He is pointing out that people in the top brackets pay a lot more money

in absolute numbers in taxes than people in lower brackets, and therefore say a 5-percent or 10-percent rate reduction on an across-the-board basis would produce larger absolute dollar reductions for those people paying the most taxes. I think that what you have here is a question of income growth versus income redistribution. I think that is one of the major points of disagreement between Joe Pechman and myself, and I am recommending to you incentives for economic growth so that you will have a tax base that gives you some prospect of paying off all of the promised future benefits that the Congress has already legislated. And Joe is more concerned with continuing to redistribute income through the Federal budget and to add to these future claims without adding to the potential of the economy to make good on them. So I think one thing the committee has to keep in mind, is that there always has to be some balance between the bills that you incur with redistribution and the capability of the economy in making good on those payments.

I think there is one point of agreement between Mr. Pechman and myself, and that is that he does support my point that the deficit is due to growth in spending. His own estimate that the deficit will be larger than projected, is because he estimates that the Congress and the administration will not be successful in controlling the growth of spending, and therefore the additional budget deficits will be due to spending taking an even larger share of GNP than the all-time peacetime high projected for 1982 of 24.2 percent. So what he is basically recommending is that spending continue to grow as a percent of national income, and that you continue to allow taxes to increase in order to fund that spending, and that is basically the position that he is recommending. I am suggesting that you take into account that spending has already grown faster than the capability of the economy to produce in real terms the resources to make good on the promised benefits, and therefore the main problem we have is to focus on the ability of the economy to make good on the benefits that are already on the books.

Mr. PECHMAN. A point of personal privilege. I did not use inappropriate statistical procedures; I used simple arithmetic. It is true that the tax cuts are in percentage terms and that they are uniform throughout the income scale. But when you correct for inflation, the tax cuts vary over the income scale. They vary from tax increases at the bottom below $20,000 to tax cuts of about 4 percent between $15,000 and $20,000, to 28.6 percent for people with a million dollars or over. So it was not a uniform cut in effective tax rates at real income levels. It was a very, very substantial cut in the top brackets, and a tax increase in the bottom brackets.

Mr. FELDSTEIN. I wanted to follow up on Joe Pechman's earlier comment. What I said in my testimony was that the tax reductions, 23-percent tax reductions would just offset the increased taxes that would otherwise be paid because of rising income passing through higher brackets between 1981 and 1984, and I still believe that is a correct statement. Over those 4 years a reasonable estimate of the annual rate of growth is about 10 percent for personal incomes including inflation and real growth. Given our progressive tax structure, 10 percent produces 15 percent additional revenue, you have to give back 6 percent just to break even, to avoid an increase in the share taken by taxes. Multiply 6 percent a

year by 4 years, you get the 24-, 23-percent cut that the administration proposed.

The reason that Joe and I came to different conclusions is that he was looking just at the inflation part of the bracket creep rather than the total increase in taxes that comes about because of inflation and real growth. I think my statement is correct, that the 23-percent cut in tax rates will actually keep people in the aggregate paying the same share of their personal income in individual income taxes that they did before 1981 began.

Now, with respect to the distribution question, without getting into the debate about arithmetic and definitions, I think what one has to ask is not what has happened over the last 2 or 3 years, but take a longer view about what has been happening to the progressivity and the burdens of taxes. The figure that I find very startling is what happens to a moderately high—I do not know what the right word is—a couple making $40,000 today of taxable income, a couple making $40,000 of taxable income would be young professionals or perhaps skilled blue-collar workers. They would pay a combined tax rate of 55 percent now on the margin. Twenty years ago somebody with the same relative income about twice the median income, would be paying 36 percent.

What we have seen for that—what we have seen for that group is a 50-percent increase in their marginal tax rate, and the current 23-percent reduction will not by any means fully undo that substantial increase in marginal tax rates for that group that I think cannot be called very wealthy, but rather crucial in that they are the key people in many professional and business careers who have choices about how much effort they wish to expend.

Chairman ROSTENKOWSKI. Mr. Conable will inquire.

Mr. CONABLE. Thank you, Mr. Chairman.

I would like to explore with the rest of the panel what Dr. Feldstein said about indexing. Some of you proposed putting that off; it has no impact until 1986. I personally happen to think that is the most significant part of the tax bill. It changes the tax system from a tax on nominal income to a tax on real income. Bracket creep has been a politician's dream. Dr. Stein said that we could be the first Ways and Means Committee to raise taxes in a long time, and we have raised taxes every year here simply by not lowering them enough to offset bracket creep.

As a matter of fact, I happen to notice that from fiscal year 1982 to fiscal year 1983, taxes grow by $39 billion in the President's budget. In other words, in one sense it is not a tax cut at all. Of course it is a tax cut over what it would have been if we had not reduced taxes, and that is of some significance, but I would like to have the other panelists comment a little about the advantage—I suppose there is an advantage in the distant future, the moonbeam period here of future deficits, in eliminating indexing. What in the world good would that do us now except to reverse a philosophical decision that we made—I like to think some of us made with some seriousness of purpose? I am sure bracket creep is a great way to finance growth if you believe in growth, but what else is a justification for doing away with indexing?

Mr. ROBERTS. Mr. Conable, I agree with you. If you do away with the indexing you will simply signal that the growth of spending is

going to continue to rise very strongly, and I think you will find that will destabilize the financial markets even more than the volatile monetary policy has and the uncertainty that hangs over them about what the tax policy is finally going to be.

Mr. SAMUELSON. I think the advantage of having an indexed tax system is that it becomes a matter of public discussion, public debate, deliberation, and explicit decisionmaking, what shall be the trend of real resource use in the American economy as between the private sector and the public sector.

Mr. CONABLE. It is an honesty-in-taxation provision.

Mr. SAMUELSON. I think that is an advantage, and I think that in many of the mixed economies of the world there has been a so-called conservative backlash because without explicit town-meeting discussion, those societies, and I include our own in part in this, have found themselves spending a larger fraction of the total through public channels. The disadvantages of the indexing procedure are twofold. One, you do lose the stabilizing properties of a fiscal system when you go to a real indexed tax system. You no longer have a brake upon the demand-pull inflation that mixed economies like ourselves are often prone to.

Mr. CONABLE. Excuse me. May I understand that? In other words, you think it is an advantage to have an automatic sopping up of some of the purchasing power if there is inflation, is that it? That is automatic, is that what you are saying?

Mr. SAMUELSON. Yes. In the past, inflationary movements would have been larger and deflationary movements would have been larger if you had a system which was indexed as compared to one which is in nominal terms.

Mr. CONABLE. Assuming Congress did not respond to economic necessity.

Mr. SAMUELSON. Right. But if Congress is responsive in the short run to economic necessity and the other considerations which prevail, then, of course, you do not need an automatic system of one kind or the other. The two translate one into the other very well.

I want to go on to the second disadvantage of the present situation. The American electorate has not yet persuaded itself to cut down on the trends of expenditure as a large part of the American electorate think ought to be done. So the tactic is being used to engineer a decision to cut down on spending not by a free-for-all public discussion, but by not having the Government have the money to do it. And since we have this divided electorate with respect to what the proper fraction of the GNP that ought to go through public hands is, there is a danger that I want to point out to you.

We have for example Professor Feldstein, who thinks going back to the percentages of 1970 is the appropriate magnitude. There are others on this panel whose value judgments might put the number higher. That is very hard to resolve through the legislative process.

Mr. CONABLE. In other words, Doctor, may I summarize that argument on your part. You are afraid that indexing will become the engine driving fiscal policy, is that it?

Mr. SAMUELSON. Let me develop the argument. One of the difficulties has been that because of the unresolved political decision-

making with respect to expenditure and because the starving of the Government revenue is being used at least by part of the debating parties as a way of precipitating that decision in the direction which they would like to have, there is a danger that we will run to deficits which are hard on investment and which in certain contexts could be inflationary and in other contexts could be actually deflationary. It is my duty as a technical economist to point out the differences in a regime in which indexing is embraced and in which indexing is not.

Mr. PECHMAN. I would like to add to what Dr. Samuelson said. I would agree that it would be all right to retain indexing, but as you said, indexing costs $30 billion in fiscal 1986 and $51 billion in fiscal 1987. We cannot afford those revenues. I think you and I could agree on tax increases that would raise that amount fairly and not hurt the economy. If you would persuade me that at the same time that you kept indexation, you would also raise taxes to offset the revenue loss, we can play ball. But under the circumstances, I am afraid you cannot persuade me that you can get that much money in other ways.

Mr. CONABLE. I like to play ball. I think Martin Feldstein is entitled to a response on this. It was his comment that brought me to ask the question.

Mr. FELDSTEIN. I think you quoted me accurately before. I think that it is a mistake to avoid facing up to the issue of whether we want to raise taxes, and I think that forgoing indexing would continually hide the fact that we were raising taxes of very substantial magnitudes without having to put it to a real vote.

Chairman ROSTENKOWSKI. Mr. Bailey will inquire.

Mr. BAILEY. Thank you, Mr. Chairman.

I would really like to ask all of you, particularly if you will think back on the comments of Dr. Samuelson—I am grateful for your textbook, by the way; I was weaned on it—concerning the automobile and steel industry and the settlement, productivity problems in those areas, you raised wage rates as an issue.

Obviously you have some problem with reinvestment, because you are talking about the neutrality in the code in your statement, in the investment-incentives section of your statement, and you made reference to expensing, which we advocated here in the Ways and Means Committee.

Of course you obviously did some work on effective tax rates and compared the ITC schedules and accelerated depreciation and what not, and you brought in leasing. It violates, of ccurse, what you seemed to indicate earlier on, and the gentleman from New York, Mr. Conable, is a true scholar in the area. His desire for neutrality in the code I respect, but you really seem to be saying that you are fearful of reinvestment problems and the implication for productivity in this economy.

Maybe I missed something in what you said. Certainly those policies would be a neutral approach to the code. I assume you would say that accelerated depreciation as we have written it creates distortions; that would be your premise, I am sure. What would you suggest we do? If you gentlemen are familiar with the administration proposal, I think they want to raise $2 billion or $3 billion or so I think the first year out. I am not sure what the revenue esti-

mates are—on minimum corporate tax, et cetera. Mr. Roberts, you mentioned in your statement that there is a predictability problem with determining what we are going to do with some of those depreciation and leasing operations.

I think we need to do something in that regard, because I would hope you gentlemen are familiar with foreign tax codes and some of the relationships in those countries between their business community and the investment program. What do you suggest we do to come up with alternatives or better suggestions on how to deal with that administration proposal? You have to be familiar with it. If you are not, forgive the question.

Mr. PECHMAN. To elaborate the point you made about the difference between ACRS and expensing, ACRS was a generous increase in depreciation allowances. It more than offset the impact of inflation, and in a better economic climate my guess is it would have a substantial investment incentive effect, which was the purpose of the provision.

Mr. BAILEY. Which some of us think the country needs.

Mr. PECHMAN. Yes. However, many economists believe, and I agree that the distortions that you create by ACRS are unwise, and that if you want to be as generous as you were with respect to depreciation allowances, you ought to substitute expensing for ACRS. That does not gain any revenue, but at least it eliminates the distortions. But then coming to the second part of your question, what would I do to raise revenue from the business community, I think the minimum corporate tax proposal is certainly a second- or third-best proposal, and I would try to avoid it if I possibly could. I think that it does by the back door what you want to do by the front door. There are certain provisions in the tax law, like interest deductions and tax-exempt industrial development bonds, that should be examined. You and I may disagree about percentage depletion, but there is a whole list of things included in the tax law that could be modified. If you do not like certain provisions, you ought to eliminate them, and that would increase the yield of the income tax. That would be the correct way of doing it. The corporate minimum tax permits you not to avoid the question of amending the code.

Mr. BAILEY. What is your attitude toward refundability and transferability?

Mr. PECHMAN. Refundability is an essential feature of any tax system.

Mr. BAILEY. God bless you, Doctor.

Chairman ROSTENKOWSKI. I guess you said enough, Mr. Bailey.

Mr. Pickle will inquire.

Mr. PICKLE. Thank you, Mr. Chairman.

Dr. Feldstein, you stated in your testimony that we ought to make some suggested cuts in social security. You are one of many who want to balance the budget through social security cuts. You make your statement, we ought to go back to returning to an earlier standard of eligibility in the disability program. I do not know what you mean by earlier standard of eligibility. Could you explain that to me.

Mr. FELDSTEIN. Yes. As you know, sir, the number of disabled—per capita disabled in the sense that they are eligible for disability

benefits under social security has roughly tripled in the last 10 or 12 years. I do not think we as a country are sicker than 12 years ago, but a number of administrative changes were made in the rules for qualifying for disability. For example, the period of time that an individual had to be disabled for.

Mr. PICKLE. Are you saying—the regulation has 20 out of 40 quarters. Should we go to 6 out of the last 13?

Mr. FELDSTEIN. No, the future prospect. The previous rule was permanent disability, and now temporary disability is allowed.

Mr. PICKLE. Are you saying we ought to go back to medical determination only?

Mr. FELDSTEIN. I think we ought to go back and reconsider what the administrative changes were that led to a tripling of the number of beneficiaries.

Mr. PICKLE. The President recommended that disability coverage be cut from 90 million to 60 million. Would you reduce it that much or in that area, is that what you are saying?

Mr. FELDSTEIN. I think it would amount to that.

Mr. PICKLE. I understand that was a recommendation, but it bothers me that you cut disability benefits by a third, and you cut the amount they receive in the general program by about half. It seems to me that would be harsh and unfair. Did you know that the rate of disability denial now is the highest in the history of the program?

Mr. FELDSTEIN. That just says that many, many more people are applying because the number of people that get through the test and are now deemed to be eligible is higher than it has been in the past.

Mr. PICKLE. We have a large rate of denial is because people are——

Mr. FELDSTEIN. We have opened the gates pretty wide, and people have decided if it is that wide maybe they can get through.

Mr. PICKLE. That is a painful adjustment for the individuals. I think that is a painful approach. Mr. Roberts, you say we have a David Stockman recession. Why do you call it a David Stockman recession?

Mr. ROBERTS. Mr. Pickle, for publications that are not scholarly journals, you usually lose control of the titling. This applies to for instance the New York Times, the Washington Post, and to most any kind of publication that is widely read. Editors select titles. Nevertheless, I am not in any great disagreement with that title, and the reason it was put on the article, I think, is that it tells the story of the decisionmaking process in which we moved from a bold policy of trying to have some real up-front tax-rate reductions in order to try to alter the growth potential of the economy, to a policy of delaying and putting off the tax cuts in an effort to maximize revenue collections in the effort to balance the budget.

Mr. PICKLE. You think Stockman caused that and the delay of the tax cut? Do you blame him for that?

Mr. ROBERTS. He was the central figure within the administration, but I also blame Congress.

Mr. PICKLE. Do you think he made that decision with the concurrence of the administration and the President?

Mr. ROBERTS. I think he made it with the concurrence of the Congress.

Mr. PICKLE. Do you think he made that decision contrary to what the President would ask or request or allow?

Mr. ROBERTS. I do not think the administration——

Mr. PICKLE. Do you think he made that decision contrary to what the President recommended?

Mr. ROBERTS. Mr. Pickle, I think the President or Mr. Stockman and probably not even Congress realized that they were moving into a recessionary situation. At the time a lot of people were going on about the terrible inflation we were about to have, how this inflation was going to be caused by the tax cuts, and I think——

Mr. PICKLE. Because we have a recession now you say Mr. Stockman brought it in. You are trying to make Mr. Stockman the fall guy and scapegoat on a decision made by the administration and jointly by the Congress, and I find it odd that you want to pin that on Mr. Stockman and not somebody else.

Mr. ROBERTS. When he comes up with the social security cuts, I hope you will also defend him again on that occasion.

Mr. PICKLE. We are getting to that area now. You want to balance the budget by the social security cuts, and so did Mr. Feldstein and Mr. Stein. We have made very material cuts in social security in this last year. The question of whether you balance the budget on social security is the question of whether you ought to have social security in the budget at all. Do you think it ought to be in the budget?

Mr. ROBERTS. I would like to balance the budget through economic growth. If we get into a pickle——

Mr. PICKLE. I have a hard time grabbing a handle on you. You do not want it to be in the budget, or you think it should be?

Mr. ROBERTS. I think that——

Mr. PICKLE. If it is in the budget, you want to make the cuts. If we take it out, it would not have anything to do with the budget. I am trying to find out if you think we ought to take it out of the budget entirely.

Mr. ROBERTS. Not unless you have another way to fund it.

Mr. PICKLE. I am trying to cover the territory. Do you think Congress did right last year in making the individual tax cuts? We only got the 5-10-10, not the full amount. Did we do right taking the 10-5-3 depreciation approach? Mr. Feldstein says yes.

Mr. ROBERTS. Something had to be done about the depreciation allowances.

Mr. PICKLE. Do you agree with what we did about capital formation, the IRA's, the R. & D. credits, do you think the capital formations provisions have helped?

Mr. ROBERTS. I agree with the thrust of it.

Mr. PICKLE. The President takes credit for it, and you say the recession we have is Mr. Stockman's recession.

Mr. ROBERTS. I think if you will read the article you will find that it gives you an account of a decision process by which the policy moved from a bold cut in tax rates to delaying them in order to maximize revenue collections in an effort to balance the budget. As I point out, that process failed, and therefore I do not see any-

thing to be gained by continuing this process which has already failed. We did not balance the budget; we unbalanced it.

Mr. PICKLE. Would you support a move now to accelerate the tax cut for 1982—move it up to January 1 instead of July? Would you be for that?

Mr. ROBERTS. I would have been for it earlier——

Mr. PICKLE. Why not now?

Mr. ROBERTS. If there is no sign of a recovery I would be more for it.

Mr. PICKLE. We have to choose yea or nay. Do we accelerate, and if so, what effect would it have on recovery? Do you think we should do something in view of the looming large deficit now? Should we take any specific act now with respect to the tax cuts?

Mr. ROBERTS. I do not think we should further delay or suspend some of the tax cuts as some of the panelists suggested, because I think that would not help the recovery, and therefore would not help the budget deficit. The reason we have such a large deficit is because we did delay the tax cuts, and that I think contributed with the very tight monetary policy over 6 months of last year to producing the recession, which unbalanced the budget.

Mr. PICKLE. If we do not delay it or accelerate it, then you feel we ought to hunker down and wait for the supply side to take effect a year from now and ride it out; is that correct?

Mr. ROBERTS. You can call it the supply side. Some of my colleagues here may call it the demand side.

Mr. PICKLE. You worked for Mr. Kemp, did you not?

Mr. ROBERTS. Yes, in 1975 and 1976.

Mr. PICKLE. What does he call it, the supply side——

Mr. ROBERTS. Supply-side economics. It stresses the point that tax rates affect relative prices and incentives in addition to demand or spending.

Chairman ROSTENKOWSKI. Dr. Feldstein, would you like to comment?

Dr. FELDSTEIN. I will pass.

Chairman ROSTENKOWSKI. Dr. Samuelson, would you like to comment?

Dr. SAMUELSON. I would like to make one comment.

I do not know whether David Stockman has an important causal role in what happened as against what some other people in the administration wanted to happen, and I do not know whether he should be censured for such a role or be praised for such a role, but I do want to comment on what those people who have studied supply side economics most carefully have found. I believe it is Mr. Roberts' conviction that things would have gone much better if the whole of the recommended dosage had been legislated by you last year.

I want to review with you what Edward Dennison, our most assiduous scholar in the study of productivity, has learned over the years from the actual data; and what other people have found who have the job of trying to explain after the fact and before the fact what net capital formation will be; I think of people like Prof. Dale Jorgenson, Professor Eisner at Northwestern University.

A year ago the testimony of these people was ruled out in the discussion because I remember being told "It is a new era, forget

your old-fashioned economist, your neoclassical economists. We have a new President, a new era." I think things have worked out about the way one might have expected them to on the basis of these previous studies, although we have had some bad luck in addition.

The point I want to address myself to is that I know of no empirical studies that buttress the view that there is some threshold effect where the thing catches on in a big way as it was described that it was going to do a year ago if you do it in that dosage, and that inadequate dosage really can alibi what has happened.

Economics is not an exact science. Mr. Roberts can remain in the belief that what he said last year and what he reiterates today have been confirmed by the facts, but I want to report that a panel studying this sort of thing would not in any preponderance be in agreement with that view.

Mr. ROBERTS. I think my position today is exactly what it has always been, and my position is if you cut marginal tax rates, you alter relative prices. That is the point of dispute between people who have that perspective and an older group who did not, who said you only alter disposable income.

My position is, and that of the supply-siders, if you cut marginal tax rates you affect two important relative prices. One governs people's decisions on how they allocate their existing income between consumption and saving, and another governs the decision on how they allocate their time between leisure and work effort or leisure and investment in their human capital. You cut the marginal tax rate, you increase the after-tax rate of return to all forms of income-earning activity. I think if you do that, you will get some more of that activity.

Chairman ROSTENKOWSKI. Dr. Roberts, do you think the Government should create incentives for investment? Do you think that the revisions to the IRA and the Keogh plans enacted last year have created an environment for investment? I am talking in particular about investment incentives for individuals.

Dr. ROBERTS. Your efforts to have saving incentives are I think in the right direction, although there are more efficient ways of producing saving incentives. There were proposals in the Congress such as the Brown-Roth-Rousselot bill. You basically need to reduce the marginal rate of tax, the rate of tax on additions to income in order for those supply-side incentives to work.

But to finish my defense against Mr. Samuelson's attack, since my argument is a relative price argument and since the personal tax cuts have not gone into effect, but are scheduled for later this year and next year, until they are in effect the relative prices have not changed and therefore you could have no positive incentive effects.

You could have a perverse incentive effect. When you legislate in the present tax cuts to take effect in the future, you run the risk of encouraging people to shift forward in time their income-earning activities, thereby reducing the tax base of the present, and to shift forward to the present their tax exemptions and tax deductions because they are worth more the higher the rates, and therefore you can have some perverse effects in that way on economic activity and the deficit.

But since the relative prices have not changed and will not be changed until the middle of 1983 and are far away, and since we do not know at this time, given some of the recommendations, whether the tax cuts will even be present, it is very difficult to say that we have the policy in effect. We have the potential of having the policy in effect in the future if we reach it.

Chairman ROSTENKOWSKI. Dr. Pechman, would you like to comment?

Dr. PECHMAN. I just want to make two points. I want to endorse what Mr. Pickle said. The Congress enacted the Reagan program almost lock, stock, and barrel. The only major change that was made by the Congress is something that both Martin Feldstein and Craig Roberts approve, and that is you substituted for a 5 percentage point cut in tax rates below the top bracket the saving provisions that cost about the same amount of money.

But even including that, the revenue loss from the bill that you passed was identical to the revenue loss proposed by the President except for the 3 months' delay in the effective date of the rate cuts from July 1 to October 1. That is one point. So that I do agree with Mr. Pickle that we have given the Reagan program a chance to operate. You adopted it.

With respect to the impact of future tax rates, I thought that saving is more or less a longrun decision on the part of households. If a household knows that 2 years out its marginal rate on the saving will decline, it will act accordingly.

As I interpret Paul Craig Roberts, he would have put these marginal tax rate cuts into effect on July 1 or October 1 of last year; instead of the deficit that we now expect of over $100 billion, he would have had a $300 billion deficit. That would not affect the economy according to Craig Roberts, but I think that it might have done a lot of damage.

Chairman ROSTENKOWSKI. Mr. Holland will inquire.

Mr. HOLLAND. Thank you, Mr. Chairman.

I just would like to ask the panel if any of you gentlemen have an opinion about whether or not the administration's proposals for deficit reduction for fiscal years 1983, 1984 and 1985 go far enough?

Dr. PECHMAN. As I indicated, I do not think they go far enough.

Mr. ROBERTS. But that is because he would recommend that you raise taxes, not that you cut spending further.

Mr. HOLLAND. Both cutting spending and raising taxes leaves us in 1983 with a $91.5 billion deficit; after you cut the spending and raise taxes in 1984 you have an $82.9 billion deficit, and in 1985 after raising all these taxes and cutting spending, you still have a $71.9 billion deficit.

What I am asking is how can you defend this sort of approach to balance the budget—do we go far enough in either direction or does the administration go far enough in raising taxes and cutting spending to try to reduce that deficit?

Mr. FELDSTEIN. My sense is that it does not go far enough and what worries me is not the deficit this year or next year as such but the fact that even out in 1985 and 1986 that deficit has not been brought more rapidly down to zero.

I think the important thing is what happens over that longer term, that there be an explicit program for bringing the deficit

down by very gradually shrinking our level of spending so that it matches up with the tax revenue that follows from the tax cuts that you passed the last year.

Now, if Congress is prepared to do that, then I think it can reduce some of the adverse effects of crowding out investment along the way by postponing the tax cut.

Mr. HOLLAND. Incidentally, Mr. Roberts, you stated that these deficits were only a small percentage of the gross national product.

Mr. ROBERTS. No, I said they were a smaller percentage than the deficits after the 1974-75 recession. Deficits in 1975 and 1976 were larger as a percentage of GNP.

Mr. HOLLAND. I tend to think the administration does not go far enough in cutting spending more and raising taxes more—a combination of those two approaches—to even more reduce the deficit.

Mr. FELDSTEIN. The specific thing that I suggested in the testimony was to slow the growth of spending, I do not think really more than the administration has called for, but in a different way. I think that the possibility of bringing down nondefense spending growth at 2 percent a year would be greatly enhanced if one had a broader range of activities to which those cuts could be applied than the narrow range that the administration chose.

The specific suggestions that I laid out that would lead to a balance after 6 years or so also called for slowing the rate of increase of defense spending back to 7 percent a year real increases that the administration had originally called for, and as far as revenue goes, the only significant increase in revenue as opposed to merely a postponement of the tax cut would be the result of natural gas deregulation.

Mr. ROBERTS. Mr. Holland, I would just point out that the budget figures show that spending continues to grow faster than the economy, so I am not sure what spending cuts we are talking about.

The proportion of GNP that goes into Federal spending has risen substantially over the level of 1980. It has risen from 23 percent of GNP to a projected 24.2 percent of GNP this year, and Mr. Pechman says that the spending estimates are very much unestimated and therefore we are probably talking about 25 percent of GNP.

So I do not see any reduction in the growth of spending. It is continuing to grow faster than the economy, and therefore, if you want to balance a budget in a situation in which spending grows faster than the economy, you will never succeed. You will chase it by raising taxes, but you will then have to contend with the adverse effects of those higher taxes. And if they are adverse, they then will affect the economy's performance, thereby affecting revenues.

I could design for you a tax increase which would widen the deficit.

Mr. HOLLAND. Thank you, Mr. Chairman.

Mr. PICKLE. The Chair will recognize Mr. Anthony at this time.

Mr. ANTHONY. Thank you, Mr. Chairman.

I would like to pose this question to the panel as a whole, but I would like to have each one of you respond. I have been going into my district, as has every Member of Congress. I have gone to the man on the street, to the businessman, I have gone to the small

merchant, I have gone to the farmer, and I hear one distinct message.

They are not talking about the budget deficit because they do not really understand the large numbers involved in the budget deficit nor really what drives the budget deficit. The gentlemen understand one thing, and it is because they go to the bank and ask to borrow the money and either have to pay 15 or 22 percent or some figure in between. They can calculate what the straight cost is no matter what type of business they are in.

I want you to answer a simple question, because they asked me and I cannot give them an answer. How can we bring down interest rates so that they can survive in 1982?

Mr. FELDSTEIN. By reassuring lenders that the inflation rate is coming down.

Mr. ANTHONY. I can point out to you that the inflation rate has developed below a double-digit figure. It has stabilized at 7.5 to 8 percent. I am telling the financial markets that every day and they are not listening.

Mr. FELDSTEIN. They are worried I think that, although progress has been made and has been made largely because of a tight monetary policy, it is not clear that that tight monetary policy will continue in the future. It is not clear that the administration or the Congress or both will not put substantial pressure on the Fed to do what the Fed has been forced to do in the past to accommodate large deficits by absorbing them into its own portfolio, thereby increasing the money supply and raising the rate of inflation.

It is that fear—it is the high real interest rates that bother your borrowers, and it is that they, the potential borrowers, cannot be sure they are going to get the high inflation rate, while the potential lenders are worried that they may face a high inflation rate. So we get these very high rates at which nobody wants to borrow.

Mr. ANTHONY. Mr. Pechman?

Mr. PECHMAN. Two things need to be done, and they should be done simultaneously. First, I think the Congress should make it crystal clear that it does not intend to tolerate the large rising deficits in the out years, 1984 and 1985. At the same time, it should seek an accord or agreement with the Federal Reserve that an easing of the monetary policy would be appropriate.

Such an accord in the face of the fact that we have had to reduce unemployment in order to moderate inflation would help. In other words, we have been running the wrong kind of mix between monetary and fiscal policy. We have had loose fiscal policy and tight money.

We ought to try the kind of medicine we used in the early 1960's. It was so effective.

Mr. ANTHONY. I take it you disagree with that?

Mr. FELDSTEIN. That is what worries the financial community.

Mr. ANTHONY. That will drive inflation up, and the economic recovery will not be there, and we will stay in a recession or depression?

Mr. Roberts?

Mr. ROBERTS. Let me point out what I mentioned in my testimony, the financial markets have known nothing but rising deficits. That has been the case for 20 years. They are born to this condi-

tion. I don't believe that all of a sudden a 20-year situation has got them panicked, because they have had nothing but high and rising deficits.

I think that the real problem is that we have not discovered what are the conditions for monetary stability.

Mr. ANTHONY. During that same 20-year period we have had rising Federal deficits, at what period of time did we have interest rates and real interest rates below 9 and 10 percent?

Mr. ROBERTS. I would have to have the statistics in front of me.

Mr. ANTHONY. Several of those years, did we not?

Mr. ROBERTS. If interest rates were 3 percent and they to go 6, that seems awfully high to the people when they go to 6. If they are 6 percent and go to 9, that seems high to the people who are used to 6, so rising interest rates are not a new feature of our economy.

Mr. ANTHONY. What is your prescription?

Mr. ROBERTS. There is nothing unusual to a deficit, or a rising deficit.

Mr. ANTHONY. What is your prescription, simply stated, to get interest rates down in 1982?

Mr. ROBERTS. We have got to discover what are the conditions for monetary stability.

Some people thought that it was monetarism, that the Fed assuring people that it would have a steady, predictable money growth path, that this would do the trick.

We don't really know if it would or wouldn't, because we have not had a steady, predictable money growth path, so then the question is, well, why haven't you? Is it because the Fed won't deliver it, or is there something difficult about doing so?

Either way, you have a problem. You have to find out which is the answer there before you know what to recommend next.

Mr. ANTHONY. Don't you think one of the severe problems that we have had, as far as M_1, is the definition of M_1, trying to come to grips with it, and we have money market certificates, and a lot of different components of money that we are not really sure whether to put it in the definition, and so you have this figure that gyrates up and down.

Mr. ROBERTS. You may be faced with innovation in the financial markets, but the Federal Reserve should be able to control the monetary base, because the central bank has to be able to control its assets and its liabilities.

If it can't control its assets and liabilities, then that is a very farfetched and hard thing to believe.

Mr. ANTHONY. Go ahead.

Mr. ROBERTS. For many years the Federal Reserve had a policy of pegging the interest rate and it gave a certain stability to markets, but apparently there developed a problem with pegging the interest rates, at least according to some of the interpretations.

They pegged the interest rates under certain conditions by making a lot of money available.

This process of making a lot of money available to hold down the interest rates ceased to do that, because it raised the inflation rate, and with it the interest rates, and as that process continued, it also raised inflation expectations. Inflation expectations started run-

ning ahead of the interest rates, so there you had the breakdown of a policy that had been maintaining some stability by pegging the interest rates. The monetarists apparently prevailed in explaining what had happened and suggested that the Federal Reserve peg the growth of the quantity of money instead.

Now, this has not occurred. It is true, it is the policy, they are supposed to be doing that but they are not. It is not being pegged on any quarterly pattern or on any regular basis. It is the extreme volatility, and last year was the worst ever, which causes a great deal of uncertainty.

Mr. ANTHONY. If we have done that since October 6, 1979, and we are in 1982 and have the same problems, at what point do we have to admit maybe the monetarism viewpoint is not creating the desired stability, and let's get rid of it?

Mr. ROBERTS. We don't know whether it won't or whether it is being implemented. We don't know whether the problem is the Fed or the monetarists' view. That is why I said the critical problem that we face is not on the fiscal policy side. It is on the monetary policy side.

Mr. ANTHONY. Let Mr. Samuelson answer.

Mr. ROBERTS. What are the conditions for monetary stability?

Mr. ANTHONY. Mr. Samuelson.

Mr. SAMUELSON. The fact that Professor Feldstein and I face, as we go into the Wall Street zoo, is high real interest rates. I have not found the usual explanations adequate; namely, that people must be extremely apprehensive that the rate of inflation ahead is much worse than everybody else thinks. So I look for independent evidence in the money market that people there actually have very pessimistic views about the future rate of inflation; and I cannot report in the period when rates have moved high any independent evidence that that is what has been driving the situation.

A monetarist who thinks the most important thing in the world is to have the rate of growth of the money supply be stabilized and who cannot complain in the last year or two about the yearly rates of change in the money supply, has suddenly had to adopt the view that the short-term variance of the rate of growth of the money supply must be the reason.

I may say this shows a surprising lack of confidence in the ability of the money market to adjust to short-term movements, and an ability which I do not think is lacking there, but it is quite wrong to think that the people in the money market are convinced as so many people in the academic life are, that it is the Fed which is the sole or by all odds the most important. They are worried about the deficit.

Now, it may well be that I can tell them not to worry about a recession deficit and get the strong reinforcement of Dr. Roberts on the same point, but these people can lose $100,000 in the financial instruments market in a week, if not in a day, and there are many self-fulfilling movements, so I come back to your question, what can you do about it.

There is very little you can do about a situation in which a self-fulfilling movement is taking place in a speculative market, so that people on both sides of the transaction believe that a high real rate of interest is what clears the market.

The short-run is short and in the end markets have to clear over a longer period of time, and the betting odds are that these real rates of interest are not sustainable, but again you come to the question, what can you in the Congress do in a responsible way?

I think, throughout the 1980's, if the U.S. Government chronically runs a deficit, because it continues to vote expenditures in excess of the tax receipts which it legislates to collect, that will be one of the hardest things upon the real rate of interest and the effects can be more ominous than Professor Feldstein allowed for. He allowed that that might have a crowding out effect upon investments, but said it cannot in a less than fully employed economy have a crowding out effect upon real income and real employment.

I think I can almost see the LMIS diagrams that Professor Feldstein wasted a brilliant youth on, but the moment you put into the LM diagram to determine the rate of interest as an independent variable, the deficit itself, even though a number of academics might say it ought not to be there and they ought to shake themselves and get smart, then the comparative data system changes very realistically, and I have been surprised at how much I can rationalize the concurrent events after the fact.

I am especially good at rationalizing them after the fact, but sometimes before the fact by putting in that variable which didn't used to be in the liquidity preference schedule.

While it is there, it is there, and I don't think you gentlemen are in a good position to exercise it.

Mr. ROBERTS. I am going to go back and make my same speech and talk about Harry Truman's commissions, because they always said on the one hand, we are going to do this, but on the other hand, we are going to do that.

I think the problem is simply this, that the public has been beat over the head with some simplistic answers to a very complex problem, and the four of you have just proven that. You can't solve the economy with very simplistic political rhetoric, and we have some long-term structural problems we have got to try to get in.

I have one final question for the record. I would like to have them answer this for the record.

Failing to get interest rates down in 1982, you have acknowledged how difficult it is going to be, failing to get them down, what help, if any, do you suggest that we give for the housing industry, and automobile industry, the savings and loan industry, and the small business and the farmer?

If we provide them any immediate help in 1982, what impact do you think that would have on the deficit and the financial markets perception of what the Congress is trying to do to stabilize the economy?

Chairman ROSTENKOWSKI. We will send that question to you.

Mr. Hance will inquire.

Mr. HANCE. I have several questions for you as a group.

On the first one, and I would like you to answer either yes or no. In looking at the President's budget for 1983 and what you know of the budget, do you believe that if it were passed as is, that the deficit figures that they estimate would be correct?

Mr. FELDSTEIN. No, can I add an "if"?

If the Fed continues to do what it has said it is going to do and what I think it should do, if the Federal Reserve continues to pursue the kind of relatively tight policies, then I think the administration's budget forecasts will prove false.

Mr. PECHMAN. Even if all of the proposals that the President made were adopted, the deficit is substantially underestimated in the forseeable future.

Mr. ROBERTS. Your question implies that the spending cuts are granted.

Mr. HANCE. Say it was passed as is.

Mr. ROBERTS. In that case, I would say the 1983 budget deficit would be pretty much on the mark subject to the behavior of the Federal Reserve Board.

Mr. SAMUELSON. I think the administration estimates are too optimistic, and I notice that in a roundup of 42 business economists a rather conservative group by my standard, 1 year ago, 67 percent believed that by the mid-1980's, the administration goal of balancing the budget would be realized and in February, an all-time record for unanimity was achieved. Zero out of 42 business economists believed that that was a reasonable achievement to be expected.

Mr. HANCE. Regardless of your personal feelings about the cuts, how many of you would feel that there should be more cuts than the President has proposed, regardless of where they would come from?

Mr. ROBERTS. Spending cuts or reductions in spending growth?

Mr. HANCE. Reduction in spending, and reduction in growth.

[Show of hands.]

Mr. HANCE. Two.

Mr. PECHMAN. On spending cuts, I would hope that in addition to cutting nondefense programs, that the Congress would take a good look at defense programs as well.

Mr. HANCE. I include defense, anything, gentlemen. On increasing revenues, whether to increase excise taxes, how many of you would be for increasing revenues, in whatever position you wanted to increase them?

Mr. FELDSTEIN. Would you distinguish between permanent and temporary?

Mr. HANCE. Temporary, like postponing the tax cut to July of 1983 to January of 1984?

Mr. FELDSTEIN. That would be considered a tax increase for the purpose of this hand count?

Mr. HANCE. Right. How many of you would be for raising revenues?

Mr. SAMUELSON. I am in favor given what I think is going to be done with expenditures. Well, I think for the mid-1980's there has to be an increase in tax revenues. That does not mean that there has to be that for the year to come.

Mr. PECHMAN. I agree. You reduce the strength of the revenue system by about 20 percent by the mid-1980's. You will have to get at least half of the taxes back.

Mr. FELDSTEIN. You only have to get taxes back if you want to go on spending a much higher part of the GNP as you did in the early seventies.

Dr. Pechman means you have to continue to spend a much larger share of GNP on defense and nondefense than you did in 1970.

Mr. PECHMAN. When Martin Feldstein says he can do it, what he means is we would undo not only the increases in nondefense programs in recent years but go back to 1970, which I wish to remind you would mean undoing the 1972 amendments to the Social Security Act.

He is recommending a whopping cut in outlays.

Mr. FELDSTEIN. 1970 is a share of GNP, but the economy grows, so you do not have to cut back anything like 1970 real levels. If you phased this in over 5 or 6 years, it would get us back to the 1978 real level of nondefense spending.

Mr. PECHMAN. We ought to give Mr. Feldstein an assignment. He ought to come out and tell you really what that replacement rate he is talking about is, because he might be surprised himself.

Mr. FELDSTEIN. Currently about 90. It would be about 60.

Mr. PECHMAN. He is thus reducing the replacement rate by a third.

Mr. SAMUELSON. Dr. Feldstein's value judgments are interesting, and mine would be interesting if I bored you with them, but it is important for your committee to remember that spending and taxing decisions have to be a chicken-egg, chicken-egg simultaneous decision, and I remember the chairman asking an administration witness, do you want the tax cuts, even if you do not get the expenditure cuts, and the man squirmed, and he said "We will get them."

Finally, the chairman said, "But if you don't get them," and he said, "Yes, even under those circumstances."

I would like a question put to me to give you what your revenue estimates ought to be independently of what are your expenditure decisions.

Chairman ROSTENKOWSKI. I want to thank Dr. Roberts for joining us.

Mr. HANCE. One last question, on raising revenues, one thing that I have looked at is an oil import fee of $5 a barrel. The price of crude oil is dropping dramatically, and I think it will be as low as $25 in the next 18 months and the price of gasoline will drop also.

Will you comment on an oil import fee of $5 a barrel as a potential revenue raiser?

Mr. CONABLE. Do we want to exacerbate the disparity between the two prices with natural gas deregulation?

Mr. FELDSTEIN. If we deregulate the natural gas more rapidly, there is a very strong case for not allowing that differential to widen, therefore, for a tax of that sort.

Mr. PECHMAN. I think we undertax energy products in the United States. I would like to see some kind of tax that would really raise the relative prices of energy as compared to other things and which would, therefore, encourage consumers to conserve. So I would either have a gasoline tax, or oil import fee, combined with a windfall profits tax, which would also raise a considerable amount of revenue.

Mr. FELDSTEIN. Let me clarify my statement and distinguish it from what Dr. Pechman and what Dr. Stein said earlier.

I am in favor of a broad tax on energy, raising energy prices, but not selecting out a particular use of energy.

I do not see the case for conserving on one kind of energy product, gasoline, and not conserving on other kinds to an equal extent.

Mr. HANCE. It causes wide disparity in the market?

Mr. FELDSTEIN. We ought to have a broad tax.

Mr. SAMUELSON. The reason to be against a tax is that a tax discourages the activity which is taxed, and there are some activities which I do not mind being discouraged, and I think the national interest at this point wants them to be discouraged.

Your specific question about the import of oil, of energy, is one of those, and so the arguments that there is deadweight loss involved does not apply with the same virulence so I would be in favor of that, other things being equal.

I want to remind us that Dr. Stein, before he left, advocated an increase in tobacco and liquor, and I think there was some other, I can't remember—gasoline.

I think it is not against the national interest to discourage the use of tobacco or against the national interest to discourage the use of alcohol, and it seems to me that these are revenue sources which, therefore, can be——

Mr. HANCE. I will come back to you, sir.

Mr. PECHMAN. The last time we raised alcohol or tobacco taxes was 30 years.

I would support increases in alcohol and tobacco and gasoline taxes for the reasons that Paul Samuelson mentioned. If you do that, you ought to understand that what you are doing is imposing increasingly regressive taxes, which should be offset by increasing taxes in the higher income classes.

Chairman ROSTENKOWSKI. Mr. Matsui will inquire.

Mr. MATSUI. I would like to ask each of the gentlemen two series of questions, and I shall make them very quick.

Some 30 to 60 days ago, most economists were saying we should see recovery sometime in the spring of this year . Mr. Stockman indicated yesterday that by the fall of this year we will see recovery, and today when the President was asked that very same question on two or three separate occasions, he said he was guardedly optimistic but refused to give any time deadline.

Assuming we pass the President's program, maybe a little different mix in terms of social cuts and military spending cuts, but assuming that we pass his program with the deficit in the neighborhood of $120 billion instead of $91, and assuming Mr. Volcker continues to carry out his promise of keeping the money supply tight—in the upper levels of the range he is talking about—when do you three gentlemen envision recovery?

Mr. FELDSTEIN. I think that whatever recovery we get is going to be a very weak recovery, and therefore, whether it occurs in May or June or not until much later in the summer, or even after that, it is not going to matter nearly as much as this discussion about a precise date suggests.

I think that the combination of fundamental factors and tight money means that we are going to have a sluggish economy for the rest of the year.

I think that that should help to bring down and keep down the rate of inflation.

Mr. PECHMAN. I think that the economy will hit bottom sometime by midyear, and there will be a modest recovery. I worry more about 1983 than the latter half of 1982, because the tight money policy which the Fed is pursuing, which nobody wants to dissuade them to do otherwise, will inevitably collide with fiscal policy.

We are going to get another acceleration in interest rates and we will hit the interest rate ceiling again. We will then have a recurrence of what happened in 1981.

I think that, for the foreseeable future, unless you get the deficit under control, you are likely to have annual recessions, or recessions once every year and a half, and that is not a good picture.

Mr. SAMUELSON. Halfway between April Fool's Day and the Fourth of July comes my birthday, and so at 11 a.m. May 15, the National Bureau will announce that this recession is at the bottom.

It is not terribly important whether it happens then or a month later or 2 months later, as the professor says, but it is pretty important that it happen, and that that recession not snowball into something significantly worse, because from now on the cost-benefit ratio of what you buy and what it costs you in human consumption is getting on the dicey side, and so it is not a matter of no moment whether it occurs, and when it occurs, but going by the evidence, I do not think you are justified in thinking that we are out to go into a 1929-like depression.

Mr. MATSUI. One more question, if I may.

A couple of days ago, the Washington Post had a story that the Council of Economic Advisers had studied the ACRS that was passed last year by the Congress.

Under the old system of accelerated depreciation, the disparity and the effective tax rate was 28 percent, 25 percent to 48–53 percent, and under the new system you have for automobiles, minus 11 percent, the effective tax rate all the way up to 37 percent; do you think that this new system that we have will create a greater distortion in investment patterns than the old system?

And second, if you do believe that, do you think that this Congress and this body here should make some adjustments this year in what we did last year?

Mr. FELDSTEIN. I think what you did last year was not a perfect thing but a very good thing. It brought down very substantially total effective tax rates on all kinds of investment, particularly equipment investment. That will have a positive effect on investment.

If you try to seek out a perfect system, you will continually fail and every time you change the rules, you confuse the business community about the rules of the game under which they do business. There is no perfectly neutral system. Expensing is not perfectly neutral. ACRS is not perfectly neutral and the combination of financing arrangements and tax arrangements will continue to confound the neutrality.

You have a good system for a while, and you ought to go with it and then perhaps later on reconsider what the other possiblilities are.

Mr. MATSUI. I think, though, that we created more inefficiency in terms of investment with this new system or do you think the old system had more inefficiencies?

Mr. FELDSTEIN. The old system had many more problems and was a very strong disincentive to investment in plant and equipment.

Mr. MATSUI. Because of disparity or because the rates were higher?

Mr. FELDMAN. The total effective tax rates were very high, and you could have brought the rates down to current average level in ways that in principle provide a greater equality of rates but you have to, I think that the calculation is often presented to show that, ignores the fact that the relative use of debt in different kinds of investment situations, for different kinds of assets in different industries differs a lot, and therefore, the usual calculations of disparties are misleading.

You can't, without tying the investment rules to the debt financing mix, which I don't think you are about to do, achieve the kind of neutrality that academics talk about when they come before you.

Mr. PECHMAN. I disagree with Dr. Feldstein. I don't think the present system is a good one.

I think that you would achieve a much greater degree of neutrality if you went to expensing. As I indicated earlier, I also think you ought to substitute some degree of fundability for leasing which would improve the neutrality of the system.

If Dr. Feldstein is worried about the remaining nonneutrality after you have expensing, I will join him in eliminating the deduction for interest which is the proper way to eliminate the nonneutrality that he talked about.

Mr. SAMUELSON. I don't have an interesting opinion on this.

Mr. MATSUI. Thank you.

Mr. CONABLE. That was a remarkable statement. I congratulate you on it, and I also doubt it.

Mr. Chairman, I would like to ask a question for the record, since it does not have a great deal to do with the subject at hand, however, it does with the work of this committee, and I refer to a comment by Dr. Feldstein in this morning's Wall Street Journal article in which he advocated the elimination of the interest deduction for consumer interest, among other things.

That seems like a rather interesting proposal, because I am sure it would be, I mean, the suspicion one has, it would be rather difficult for the auto industry and it would be somewhat regressive in its nature, although I acknowledge that three out of four taxpayers are on a standard deduction but I wonder if you have any figures on that that you would put in the record that would instruct this committee on the effect of the elimination of the consumer interest deduction in terms of its impact.

It is a proposal which has been considered vaguely, and only briefly from time to time by this committee, and if you have some studies on that, their inclusion in the record would be of interest. I don't insist on an answer now.

Mr. FELDSTEIN. I will be happy to send some numbers along. It would not be regressive for the reason that you mentioned, that

most lower income taxpayers don't itemize at all and wouldn't be affected by it.

Mr. CONABLE. Obviously, well-to-do people don't buy cars on credit, either.

Mr. FELDSTEIN. It depends on how narrowly you construe consumer——

Mr. SAMUELSON. Householders, mortgage interest?

Mr. CONABLE. I am talking about consumer credit itself.

That, of course, has been one of the burgeoning areas of debt, and has been considered as something desirable in terms of getting down inflation, I mean the deduction has been considered here but not seriously considered and I wonder if there is a study available that would be of interest to the committee on that.

Mr. FELDSTEIN. I will try to send you some numbers.

Mr. CONABLE. Thank you very much.

Mr. PICKLE. Mr. Chairman, early this year or last year, the administration said that the recession ought to bottom out by the early part of this year and level off in early spring and by the end of the year we would have a real vigorous economy, and then we would end up at the end of the year with a plus 0.2 real growth in GNP, and that it would go from that point to a plus 5.2 in 1983.

Mr. Samuelson, a while ago you said that you didn't think we were going to have a recession, things would get a little better, and we go into a depression.

Do any of you feel that we are on schedule now, will we have a 0.2 real growth in GNP by the end of this year, and can we have a 5.2 plus growth in 1983?

Mr. PECHMAN. I can only refer to some calculations that my colleague, George Perry has made. The assumption of the 0.2 for the year implied that the rate of decline of GNP in the first quarter would be something like 1 or 2 percentage points; it would bottom out in the second quarter, and then go up sharply at the rate of 5 or 6 percent.

As a result of the 3 percent decline in industrial production in January and the reduction in housing starts and retail sales, many forecasters are raising the drop in the first quarter GNP to something like the kind of drop we had in the last quarter of 1981.

If we have a five point drop in GNP——

Mr. PICKLE. A minus figure?

Mr. PECHMAN. Yes, and it might be minus 2 percent for the entire year. The assumed rate of growth of about 5 percent in 1983 is also very optimistic in light of the problems we indicated earlier with a tight money policy and a loose fiscal policy, and high interest rates.

Mr. PICKLE. No question about it being optimistic.

Is it within the realm of reality?

Mr. CONABLE. It also now is a little stale.

Mr. SAMUELSON. Mr. Pickle, it is definitely an achievable number in terms of all of the business cycle experiences of the possible World War II period, to say nothing for the last 130 years.

It would not even be an immodestly high figure in terms of my experience, but given the fact that we have a constant concern not to have inflation break out again, that we have not yet exorcised that from the system, and that that is built into every policy

maker, both at the Federal Reserve level and in the Congress, weighing all the evidence, including the more recent evidence that Dr. Pechman has referred to, one has to regard those numbers, January numbers, quite stale by now perhaps, as not numbers to bet on for a prudent person.

Mr. FELDSTEIN. I think that is correct. The administration's forecasts have generally been in line with what the business forecasters have been saying to their bosses and clients about the economy, and that they have been much too optimistic for the last year, and that this year is likely to turn out to be a very flat period.

Chairman ROSTENKOWSKI. If there are no further questions, I want to thank you gentlemen for joining us.

Thank you very much. You have been very helpful.

The committee stands adjourned until 9 o'clock tomorrow morning.

[Whereupon, at 4:45 p.m., the committee adjourned, to reconvene at 9 a.m., Friday, February 19, 1982.]

ADMINISTRATION'S FISCAL YEAR 1983 ECONOMIC PROGRAM

FRIDAY, FEBRUARY 19, 1982

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The committee met, at 9:05 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman ROSTENKOWSKI. The committee will come to order.

It is certainly a pleasure to have back at the witness table one of the more outstanding members of President Carter's Cabinet, Mike Blumenthal.

Mike, I remember some very interesting discussions that we had, and certainly some of the great decisions that you made with respect to the Nation's economic policy. On a personal basis as well as on a public basis, I want you to know that it is wonderful to have you back with our committee.

I am sure that the committee is looking forward to receiving your testimony and will be guided by the advice that you present.

STATEMENT OF W. MICHAEL BLUMENTHAL, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, BURROUGHS CORP., AND FORMER SECRETARY OF THE TREASURY

Mr. BLUMENTHAL. Thank you very much, Mr. Chairman, Mr. Pickle.

It is my pleasure to respond to your invitation to come back here before this distinguished committee. It does seem a bit like old times, although I feel a lot more relaxed somehow than I did in times past. I had ample opportunity to appear before you during the 2½ years I served as Secretary of the Treasury, and I have stayed away since from any testimony before the Congress.

So, coming back here today in my first return engagement, brings back some fond memories, others not so fond. But, I do wish, in a way, that my return engagement since leaving Washington might have occurred under less somber circumstances than it is. And that is, Mr. Chairman, because the President's budget for fiscal year 1983 and his economic game plan through fiscal year 1985 are, in my view, worrisome and unrealistic. They lack credibility and defy basic economic commonsense. They are also patently unfair and lack fundamental equality of sacrifice for the various segments of our society which is so essential if any program is to

be viable and enjoy the necessary broad based support among the American people.

Unless substantially modified, hopefully through a comprehensive bipartisan effort of the Congress and the administration, the President's program is likely to prolong and deepen the current serious recession and to cause severe hardship for millions of Americans in many parts of the country. It is therefore urgent that this committee, and the Congress as a whole, enact an economic program more likely to restore sustainable economic growth without renewed inflation and without imposing undue and uneven hardship on any one segment of the population or region of the country.

I appear before you today, Mr. Chairman, speaking only for myself as a private citizen and as a businessman—albeit one with extended experience in the public sector as well. Since leaving Washington, I have returned to private industry and am currently chairman and chief executive officer of the Burroughs Corp., the second largest information systems and computer company in the world.

I also serve as director of one of our country's largest commercial banks and of the Nation's third largest insurance company. I am also a board member of a major Midwestern food company headquartered in Minneapolis, Minn.

Moreover, since leaving Washington, I have resumed my interest in higher education as a trustee of Princeton University and have worked closely with Gov. Bill Milliken in my home State of Michigan, to advise him on how best to cope with the tremendous economic difficulties we face in what is lamentably now one of the highest unemployment areas in the country.

Mr. Chairman, the budget proposals before you represent a program which is unbelievable, unworkable, and unjust. I must tell you in all frankness, and I have given this a great deal of thought, that if I had been asked as Secretary of the Treasury to support and defend such a program, I would surely have seen no choice but to tender my resignation forthwith.

This is a strong statement, Mr. Chairman, and I do not make it lightly. Allow me, therefore, to explain briefly why I have come to this conclusion.

First, as to the budget deficits. Taking the budget proposals at face value and without, for the moment, questioning the underlying assumptions, it is being suggested that we add to our national debt of $1 trillion with planned deficits in fiscal year 1982 through fiscal year 1985 totaling $345 billion more. In other words, it is being recommended that we increase our total national debt accumulated over the past 200 years by as much as one-third or more in the span of just 4 short years.

Mr. Chairman, annual deficits of such a magnitude are most unwise. They are bound to be inflationary and would condemn us to a continuation of the current monetary policy whose hallmark is interest rates at unacceptably high levels.

Double digit interest rates and, in particular, high long-term rates effectively kill off any hope for the kind of increased business investment envisioned by the Tax Act of 1981. And without more investment, there will be no sustained economic recovery, no im-

proved productivity and no lasting reduction in the current high rate of unemployment.

I have recently heard it argued, Mr. Chairman, that annual budget deficits at or near $100 billion should not unduly concern us because they loom less important than in years past when related to our current GNP of $3 trillion and more. We are also being told that the Treasury "crowding out" private investors in capital markets is not really a problem because increased savings will augment the supply of investment funds available.

This kind of economic argument is a legitimate subject for debate but, however one views it, it misses the real significance of large deficits which are psychological as much as they are substantive.

As the markets have amply shown, investors, bankers and businessmen do not buy the argument that annual $100 billion deficits are anything but inflationary. As a minimum, they can see that such deficits preempt for the Government ever increasing amounts—up to 50 percent or more at the moment—of the net credit supply available to the markets as a whole. They are convinced that in the face of these kinds of numbers, monetary policy will undoubtedly remain tight and interest rates high—and that this will continue until the deficits are brought under better control.

Under these circumstances, they cannot and will not commit themselves to the major investments we so urgently require for recovery and for growth. Furthermore, interest-rate sensitive industries, such as automobiles, housing, forest products, and others will similarly continue to remain hard hit until the deficits decline.

There is, moreover, a broad based conviction that the large deficits being proposed are simply not sustainable. It is only a question of time before they must be attacked. This, in turn, breeds a fear of sudden changes in economic policy and creates an air of uncertainty and risk which keeps long-term rates up and deepens the reluctance to commit funds over the longer run.

For these reasons alone, Mr. Chairman, it is essential that a major effort must be undertaken to trim the projected deficits substantially, bringing the budget closer to a balance by fiscal year 1984 or 1985.

Now, as to the underlying assumptions $340 billion in deficits over the next 4 years is, in itself, disturbing and untenable. Unfortunately, the assumptions underlying the President's proposals are sufficiently unrealistic as to give rise to the almost certain prospect that actual deficits would be much larger.

Projected receipts appear to be substantially overstated. In the first place, they assume for fiscal year 1983 a robust 5.2 percent growth in the GNP. As you know, each percentage point by which GNP rises less would cost the Treasury $25 billion or more.

May I say here, Mr. Chairman, that $25 billion is a minimum figure. We don't really know how much it is. I have seen other estimates that range as high as $40 billion.

Since neither the Congressional Budget Office nor few, if any, private economists project an 1983 GNP growth at this rate, the receipt numbers must be open to question on that ground alone.

Second, estimated receipts in fiscal year 1983 at $666 billion assume savings through so-called management incentives, higher

oil royalty collections, user fees and other measures of this kind which appear to me to be highly optimistic.

If the past is to be any guide, one must assume that by no means all of the $40 to $50 billion in additional receipts projected from these sources is in fact likely to materialize.

The expenditure side of the budget, on the other hand, is understated. For example, to assume an average 91-day Treasury bill rate of 11.7 percent in fiscal year 1982 implies a decline in interest rates which, with Treasury bill rates presently at 14.1 percent the last time I looked, seems dubious and cannot be squared with the rest of the economic assumptions upon which these budget proposals are based.

Declines in interest rates in fiscal year 1983 and beyond, while the economy is assumed to expand at a real rate of 5 percent or more, are just doubtful. Similarly, there is now a good chance that the unemployment rate will rise above the 8.9- and 7.9-percent average projected for fiscal year 1982 and 1983 respectively. Certainly the numbers we have seen in the last months would give some substance to that fear.

And each 1 percent point in unemployment involves added Government expenditures of at least $9 billion per year.

Finally, of course, the budget is based on the assumption that the Congress will be willing to make further deep cuts in such social programs as food stamps, AFDC, medicaid, housing, job training, education and the like. Indeed, to meet the President's budget projections, programs targeted especially for the needy, such as food stamps, AFDC, and medicaid, would have to be cut by another 12.3 percent and student loans by 24 percent, to cite just two examples.

I simply cannot believe that congressional action of this sort is likely, just when the current recession is increasing rather than lowering the needs of those least able to help themselves.

Mr. Chairman, therefore, the bottom line appears clear. The economic and related assumptions underlying the President's program are not realistic. The deficit projections for fiscal year 1982 to fiscal year 1984 are substantially too low. A more realistic though still conservative estimate indicates that the budget deficit for fiscal year 1982 might well exceed $100 billion by a substantial margin, with the fiscal year 1983 and fiscal year 1984 deficits likely to reach at least $125 to $150 billion or more. Clearly, this is a dangerous and unacceptable state of affairs and requires urgent new thinking.

Let me just say a word about fairness and equality of sacrifice. Mr. Chairman, the latest statistics for the southeast Michigan/Detroit metropolitan area, including Wayne, Oakland, Macomb, Lapeer, Livingston, and St. Clair Counties, show an unemployment rate for December 1981, of 15.1 percent. The latest breakout by gender, age, and race for the third quarter of 1981 when average unemployment was only 11.8 percent show unemployment for nonwhites to be 28.5 percent, for all teenagers 25 percent and for nonwhite teenagers a horrendous 66.7 percent.

In December 1981, these numbers were undoubtedly even worse. There are other parts of the country in the Midwest and industrial Northeast where the statistics do not read much better. To talk about merely a recession under such circumstances becomes in-

creasingly difficult. Use of the word "depression" may no longer merely be a slip-of-the-tongue.

I cite these numbers, Mr. Chairman, to illustrate why I referred earlier on to the budget proposals before you as being not merely unbelievable and unrealistic, but also unfair and unequal in the burden they would place on some people and regions in this country as compared to others.

To be sure, to rid of us inflation and to restore sustained and stable growth requires multiyear sacrifices by all. But these sacrifices must be justly distributed and based on a reasonable and fair set of priorities.

The President's economic program for fiscal year 1983 to fiscal year 1985 is sadly deficient on this point. It recommends severe budget cuts for programs targeted on the Nation's neediest, while at the same time insisting on increases in defense expenditures which substantially exceed even the 7 percent real growth target for defense which the administration suggested last year.

Thus, fiscal year 1983 defense outlays would rise by an inflation-adjusted 11–12 percent, while spending for all nondefense domestic programs would actually decline and such programs as food stamps, AFDC, and medicaid would drop by over 12 percent.

Job training and education would similarly be further cut back. In fact, as the New York Times reported last Sunday, more than half the $26 billion in cuts for all domestic nondefense programs being proposed are currently targeted on the chronically dependent and working poor.

As I said earlier, with the horrendous unemployment figure in at least my part of the country of 66.7 percent for nonwhite teenagers, I really think that is an inequality of sacrifice which needs your attention.

Thus, Mr. Chairman, the increases in defense outlays and the even greater acceleration in budget authority for defense through fiscal year 1985 are as unrealistic as the excessive cutbacks in social programs for the truly needy—given the distress which this severe recession has already caused—are unfair. I would respectfully urge, Mr. Chairman, that congressional rewriting of the budget encompass a critical review and reordering of the implied national priorities.

To deal with the unprecedented budget bind in which we find ourselves requires two courses of action: reduced spending and increased taxes. Neither is pleasant or easy to accomplish. Yet, this committee and the Congres as a whole, in concert with the administration, must develop a comprehensive package involving both approaches, thereby reducing the deficits in a manner which fairly spreads the necessary sacrifices among all segments of the society.

Turning first to the spending side of the budget, it will clearly be necessary to cut back on the administration's recommended increases in defense expenditures. Under the proposals submitted to the Congress, defense outlays would rise from $159.7 billion in fiscal year 1981 to $292 billion in fiscal year 1985, for an 83 percent increase over the 4-year period. Fiscal year 1983 outlays would increase by 18 percent over the previous year in nominal terms and by 11 percent or so on an inflation adjusted basis.

Budget authority for defense spending would rise even faster, that is, by 86 percent over the same 4 year period. Its growth in fiscal year 1983 over fiscal year 1982 is projected at an unprecendented 21 percent, or approximately 13–14 percent inflation adjusted.

Mr. Chairman, these increases are untenable. The need to strengthen our defenses is clear, but a buildup so rapid as to undermine our basic economy is not. I am not a defense expert, Mr. Chairman, but I do know this: A strong America must be economically sound as well as militarily prepared. That requires a program of slower buildup and greater balance, so that added expenditures for defense can be applied wisely and related more sensibly to what we can afford.

If the increase in defense outlays and authority were kept at 6–7 percent in real terms over the period fiscal year 1983–85, it would still constitute a substantial rise in the resources being directed toward strengthening our weapons programs.

On the other hand, a rough calculation indicates that this could save $12 to $15 billion in defense outlays for fiscal year 1983, $16 billion in fiscal year 1984, and as much as $25 billion in fiscal year 1985. The total savings over the same 3-year period would amount to at least $50–$60 billion, thus greatly easing the budget pressures presently confronting us.

Unfortunately, lowering the increase in defense spending will not suffice. It will also be necessary to look for additional revenues through selective increases in taxes and/or postponement or cancellation of some of the cuts enacted in the Economic Recovery Tax Act of 1981. Indeed, it is clear that a major reason for our present difficulties arises from several ill-conceived provisions of that legislation.

Mr. Chairman, I must say in all honesty that that was not the Congress finest hour. There are some provisions in that tax act which I think are at the bottom of some of the problems we are now facing.

Let me therefore, suggest that the sooner the Congress, hopefully together with the administration, corrects some of the weaknesses of that act, the better off we will be.

First of all, until the 1981 act, it had been normal to target roughly one-quarter to one-third of the revenue loss of tax reduction legislation toward the business sector. The 1981 act broke with this tradition: 28 percent of the revenue loss will go to business this year, but the proportion will drop to 20 percent and 18.8 percent in fiscal year 1983 and fiscal year 1984 respectively. Given the need for accelerating business investment and growth in productivity, I consider this the first mistake of the act.

Second, it is the 3-year commitment to massive tax reductions for individual taxpayers which lies at the heart of the current prospects for huge deficits in fiscal year 1983 and fiscal year 1984. That is the act's second flaw.

Third, the Congress saw fit to provide for automatic indexing of income tax brackets, zero bracket amount and personal exemption for increases in the consumer price index. Such indexing robs the Congress of flexibility in the use of fiscal policy as one of the key tools for economic management. It tends to lock in inflation, rather

than to deal with it. And it places the kind of undue burden on monetary policy as an economic management tool which, over the last year, has led to the excessively high interest rates from which the economy continues to suffer to the present day. Indexing was the third major mistake, in my judgment, in the 1981 tax act.

I would strongly urge, Mr. Chairman, that this committee review these provisions of the 1981 act and make the corrections which the experience of recent months would seem to indicate. My thoughts in this regard are as follows:

First, given the relatively limited proportion of the revenue loss going to business, I would leave as much of these reductions intact as possible. Most of them relate to the new capital cost recovery provisions and are designed to increase cash flow and to accelerate replacement and modernization of our physical plant. It is important that this program and the related tax credits for incremental R. & D. expenditures be carried forward. The business tax cuts, in general, are a key to the future health and growth of the economy. They should be retained.

Second, it will then be necessary to look at the tax reductions for individual taxpayers as the main means of reducing the projected revenue loss to the Treasury. My own preference would be to let the fiscal year 1982 cuts go forward as planned, including the reduction from 70 percent to 50 percent in the maximum tax rate for individuals. Instead, we should consider reducing and/or deferring those cuts for individuals presently scheduled to go into effect in fiscal year 1983 and fiscal year 1984 for all but possibly the lowest income groups.

With an incremental revenue loss to the Treasury from tax cuts for individuals of $40 billion in fiscal year 1983 over fiscal year 1982, and a similar loss in fiscal year 1984 over fiscal year 1983, a savings of half, or approximately $20 billion each year, would not be an unreasonable target.

Third, as part of a comprehensive package of measures to reduce the budget deficit, I would also urge that your committee search for other sources of revenue enhancement. Energy taxes and other consumption taxes should be seriously considered.

Mr. Chairman, simultaneous action on defense and on taxes then makes possible, it seems to me, an attack on what I recognize to be a difficult political issue for the Congress: the overindexation of Federal pension programs and of social security, and the rapidly escalating costs of certain other entitlement programs, all of which weigh heavily on the Federal budget.

I recognize that these are not easy matters to deal with, but it is high time that the issues be faced. A simple change in the current cost-of-living adjustment formula used for social security from full indexing to one where payments are based on the amount by which the CPI exceeds 2 percentage points would save as much as $8 billion each year.

There are, finally, other areas in the budget where the Congress must look for more sources of revenue to help close the budget gap. Elimination of certain agricultural subsidies would save several billions of dollars. And there are many other opportunities for elimination of loopholes and tax expenditures which would help spread the adjustment burden more fairly amongst us all. You, Mr. Chair-

man, and your colleagues certainly know where these golden nuggets can be found in the tax code, and I need hardly bore you with a recital of what is available.

Mr. Chairman, there are many possible ways in which the budget can be put into better shape and, no doubt, this committee and the Congress will debate these possibilities exhaustively in the weeks and months to come. I calculate that my own proposals would cut the budget gap in fiscal year 1983 at least in half and could help to move us toward an even more complete elimination of the projected deficits thereafter.

What matters is not so much which way of cutting back will finally be chosen. What is important is that the deficits are dealt with forthwith; that no expenditures—not even defense—are exempted from a general belt tightening; that the large, multiyear individual tax cuts are reduced and/or postponed at least for fiscal year 1983 and fiscal year 1984; and that whatever action is taken involves a just balancing of the burden for all concerned.

Mr. Chairman, let me conclude by indicating that it is of course a difficult political issue that the Congress confronts and that those who have to make these decisions have to struggle with. But I think the situation is sufficiently serious, and I think the markets and observers both within and outside the United States are so indicating almost uniformly, that I would certainly hope that the marshalling of the political courage, hopefully on a bipartisan basis, to deal with these matters is available. It is a difficult period. There is a lot of responsibility on your shoulders and on those of your colleagues.

I have no doubt that you can and will discharge that responsibility in the best interests of the country.

Thank you very much.

[The prepared statement follows:]

STATEMENT BY

W. MICHAEL BLUMENTHAL

CHAIRMAN OF BURROUGHS CORPORATION

FORMER SECRETARY OF TREASURY

BEFORE THE

WAYS AND MEANS COMMITTEE

HOUSE OF REPRESENTATIVES

February 19, 1982

Mr. Chairman:

I appreciate your invitation to appear before this distinguished Committee to present my comments on the Administration's budget and economic program sent to the Congress by President Reagan last week.

Having had ample opportunity to appear before you during the more than 2½ years I served as Secretary of the Treasury from 1977 to 1979, my presence here today brings back a good many memories, some of them pleasant -- others less so. I must admit, however, that I wish my first return engagement since leaving Washington might have occurred under less somber circumstances.

The President's budget for FY'83 and his economic game plan through FY'85 are, in my view, worrisome and unrealistic. They lack credibility and defy basic economic common sense. They are also patently unfair and lack the fundamental equality of sacrifice for the various segments of our society which is so essential if any program is to be viable and enjoy the necessary broad based support among the American people. Unless substantially modified, hopefully through a comprehensive bipartisan effort of the Congress and the Administration, the President's program is likely to prolong and deepen the current serious recession and to cause severe hardship for millions of Americans in many parts of the country. It is therefore urgent that this Committee, and the Congress as a whole, enact an economic program more likely to restore sustainable economic growth without renewed inflation and without imposing undue and uneven hardship on any one segment of the population or region of the country.

I appear before you today, Mr. Chairman, speaking only for myself as a private citizen and as a businessman -- albeit one with extended experience in the public sector as well. Since leaving Washington, I have returned to private industry and am currently Chairman and Chief Executive Officer of the Burroughs Corporation, the second largest information systems and computer company in the world. Headquartered in Detroit, we employ 67,000 persons in 81 plants located in 18 states and in 14 countries throughout the world. I also serve as Director of one of our country's largest commercial banks and of the nation's third largest insurance company. I am also a board member of a major midwestern food company headquartered in Minneapolis, Minn. Moreover, since leaving Washington, I have resumed my interest in higher education as a Trustee of Princeton University and have worked closely with Governor Bill Milliken in my home state of Michigan, to advise him on how best to cope with the tremendous economic difficulties we face in what is lamentably now the highest unemployment area of the country.

Mr. Chairman, the budget proposals before you represent a program which is unbelievable, unworkable and unjust. I must tell you in all frankness, therefore, that if I had been asked as Secretary of the Treasury to support and defend such a program, I would surely have seen no choice but to tender my resignation forthwith.

This is a strong statement, Mr. Chairman, and I do not make it lightly. Allow me therefore to explain briefly why I have come to this conclusion.

1. **THE BUDGET DEFICITS**

Taking the budget proposals at face value and without, for the moment, questioning the underlying assumptions, it is being suggested that we add to our national debt of one trillion dollars with planned deficits in FY'82 through FY'85 totalling 345 billion dollars more. In other words, it is being recommended that we increase our total national debt accumulated over the past 200 years by as much as one-third or more in the span of just four short years.

Mr. Chairman, annual deficits of such a magnitude are most unwise. They are bound to be inflationary and would condemn us to a continuation of the current monetary policy whose hallmark is interest rates at unacceptably high levels. Double digit interest rates and, in particular, high long term rates effectively kill off any hope for the kind of increased business investment envisioned by the Tax Act of 1981. And without more investment, there will be no sustained economic recovery, no improved productivity and no lasting reduction in the current high rate of unemployment.

I have recently heard it argued, Mr. Chairman, that annual budget deficits at or near 100 billion dollars should not unduly concern us because they loom less important than in years past when related to our current GNP of three trillion dollars and more. We are also being told that the Treasury "crowding out" private investors in capital markets is not really a problem because increased savings will augment the supply of investment funds available.

This kind of economic argument is a legitimate subject for debate but, however one views it, it misses the real significance of large deficits which are psychological as much as they are substantive.

As the markets have amply shown, investors, bankers and businessmen do not buy the argument that annual 100 billion dollar deficits are anything but inflationary. As a minimum, they can see that such deficits preempt for the government ever increasing amounts -- up to 50% or more -- of the net credit supply available to the markets as a whole. They are convinced that in the face of these kinds of numbers, monetary policy will undoubtedly remain tight and interest rates high -- and that this will continue until the deficits are brought under better control. Under these circumstances, they cannot and will not commit themselves to the major investments we so urgently require for recovery and for growth. Furthermore, interest-rate sensitive industries, such as automobiles, housing, forest products, and others will similarly continue to remain hard-hit until the deficits decline.

There is, moreover, a broad based conviction that the large deficits being proposed are simply not sustainable. This, in turn, breeds a fear of sudden changes in economic policy and creates an air of uncertainty and risk which keeps long term rates up and deepens the reluctance to commit funds over the longer run.

For these reasons alone, Mr. Chairman, it is essential that a major effort must be undertaken to trim the projected deficits substantially, bringing the budget closer to a balance by FY'84 or '85.

2. UNDERLYING ASSUMPTIONS

340 billion dollars in deficits over the next four years is, in itself, disturbing and untenable. Unfortunately, the assumptions underlying the President's proposals are sufficiently unrealistic as to give rise to the almost certain prospect that actual deficits would be much larger.

Projected receipts appear to be substantially overstated. In the first place, they assume for FY'83 a robust 5.2% growth in the GNP. As you know, each percentage point by which GNP rises less would cost the Treasury 25 billion dollars. Since neither the Congressional Budget Office nor few, if any, private economists project an '83 GNP growth at this rate, the receipt numbers must be open to question on that ground alone.

Second, estimated receipts in FY'83 at 666 billion dollars assume savings through so-called management incentives, higher oil royalty collections, user fees and other measures which appear highly optimistic as well. If the past is to be any guide, one must assume that by no means all of the 40 to 50 billions in additional receipts projected from these sources is in fact likely to materialize.

The expenditure side of the budget appears equally understated. For example, to assume an average 91-day Treasury bill rate of 11.7% in FY'82 implies a decline in interest rates which, with Treasury Bill rates presently at 14.1% seems dubious and cannot be squared with the rest of the economic assumptions upon which these budget proposals are based.

Declines in interest rates in FY'83 and beyond, while the economy is assumed to expand at a real rate of 5% or more, are just doubtful. Similarly, there is now a good chance that the unemployment rate will rise above the 8.9% and 7.9% averages projected for FY'82 and '83 respectively. And each 1% point in unemployment involves added government expenditures of at least 9 billion dollars per year.

Finally, of course, the budget is based on the assumption that the Congress will be willing to make further deep cuts in such social programs as food stamps, AFDC, Medicaid, housing, job training, education and the like. Indeed, to meet the President's budget projections, programs targeted especially for the needy, such as food stamps, AFDC, and Medicaid, would have to be cut by 12.3% and student loans by 24%, to cite just two examples. I simply cannot believe that Congressional action of this sort is likely, just when the current recession is increasing rather than lowering the needs of those least able to help themselves.

Mr. Chairman, the bottom line appears clear. The economic and related assumptions underlying the President's program are not realistic. The deficit projections for FY'82 to FY'84 are substantially too low. A more realistic though still conservative estimate indicates that the budget deficit for FY'82 might well exceed 100 billion dollars by a substantial margin, with the FY'83 and FY'84 deficits likely to reach at least 125 to 150 billion dollars or more. Clearly, this is a dangerous and unacceptable state of affairs and requires urgent new thinking.

3. FAIRNESS AND EQUALITY OF SACRIFICE

Mr. Chairman, the latest statistics for the Southeast Michigan/Detroit Metropolitan area, including Wayne, Oakland, Macomb, Lapeer, Livingston, and St. Clair counties, show an unemployment rate for December, 1981, of 15.1%. The latest breakout by gender, age and race for the 3rd quarter of 1981 when average unemployment was only 11.8% show unemployment for non-whites to be 28.5%, for all teenagers 25% and for non-white teenagers a horrendous 66.7%. In December, 1981, these numbers were undoubtedly even worse. There are other parts of the country in the Midwest and Industrial Northeast where the statistics do not read much better. To talk about merely a recession under such circumstances becomes increasingly difficult. Use of the word "depression" may no longer merely be a slip-of-the-tongue.

I cite these numbers, Mr. Chairman, to illustrate why I referred earlier on to the budget proposals before you as being not merely unbelievable and unrealistic, but also unfair and unequal in the burden they would place on some people and regions in this country as compared to others.

To be sure, to rid us of inflation and to restore sustained and stable growth requires multi-year sacrifices by all. But these sacrifices must be justly distributed and based on a reasonable and fair set of priorities. The President's economic program for FY'83 to FY'85 is sadly deficient on this point. It recommends severe budget cuts for programs targeted on the nation's neediest, while at the same time, insisting on increases in defense expenditures which substantially exceed even the 7% real growth target for defense which the Administration suggested last year. Thus, FY'83 defense outlays would rise by an inflation-adjusted 11-12%, while spending for all non-defense domestic programs would actually decline and such programs as food stamps, AFDC and Medicaid would drop by 12.3%. Job training and education would similarly be further cut back. In fact, as the New York Times reported last Sunday, more than half the 26 billion dollars in cuts for all domestic non-defense programs being proposed are currently targeted on the chronically dependent and working poor.

Thus, Mr. Chairman, the increases in defense outlays and the even greater acceleration in budget authority for defense through FY'85 are as unrealistic as the excessive cutbacks in social programs for the truly needy -- given the distress which this severe recession has already caused -- are unfair. I would respectfully urge, Mr. Chairman, that Congressional rewriting of the budget encompass a critical review and reordering of the implied national priorities.

4. CORRECTIVE ACTION

To deal with the unprecedented budget bind in which we find ourselves requires two courses of action: reduced spending and increased taxes. Neither is pleasant or easy to accomplish. Yet, this Committee and the Congress as a whole, in concert with the Administration, must develop a comprehensive package involving both approaches, thereby reducing the deficits in a manner which fairly spreads the necessary sacrifices among all segments of the society.

Turning first to the spending side of the budget, it will clearly be necessary to cut back on the Administration's recommended increases in defense expenditures. Under the proposals submitted to the Congress, defense outlays would rise from 159.7 billion dollars in FY'81 to 292 billion dollars in FY'85, for an 83% increase over the four year period. FY'83 outlays would increase by 18% over the previous year in nominal terms and by 11-12% on an inflation adjusted basis.

Second, it will then be necessary to look at the tax reductions for individual taxpayers as the main means of reducing the projected revenue loss to the Treasury. My own preference would be to let the FY'82 cuts go forward as planned, including the reduction from 70% to 50% in the maximum tax rate for individuals. Instead, we should consider reducing and/or deferring those cuts for individuals presently scheduled to go into effect in FY'83 and FY'84 for all but possibly the lowest income groups.

With an incremental revenue loss to the Treasury from tax cuts for individuals of 40 billion dollars in FY'83 over FY'82, and a similar loss in FY'84 over FY'83, a savings of half, or approximately 20 billion dollars each year, would not be an unreasonable target.

Third, as part of a comprehensive package of measures to reduce the budget deficit, I would also urge that your Committee search for other sources of revenue enhancement. Energy taxes and other consumption taxes should be seriously considered.

Mr. Chairman, simultaneous action on defense and on taxes would make possible, it seems to me, an attack on what I recognize to be a difficult political issue for the Congress: the over-indexation of federal pension programs and of social security, and the rapidly escalating costs of certain other entitlement programs, all of which weigh heavily on the federal budget.

I recognize that these are not easy matters to deal with, but it is high time that the issue be faced. A simple change in the current cost of living adjustment formula used for Social Security from full indexing to one where payments are based on the amount by which the CPI exceeds two percentage points would save as much as 8 billion dollars each year.

There are, finally, other areas in the budget where the Congress must look for more sources of revenue to help close the budget gap. Elimination of certain agricultural subsidies could save several billions of dollars. And there are many other opportunities for elimination of loopholes and tax expenditures which would help spread the adjustment burden more fairly amongst us all. You, Mr. Chairman, know where these golden nuggets can be found in the tax code, and I need hardly bore you with a recital of what is available.

Mr. Chairman, there are many possible ways in which the budget can be put into better shape and, no doubt, this Committee and the Congress will debate these possibilities exhaustively in the weeks and months to come. I calculate that my own proposals would cut the budget gap in FY'83 at least in half and could help to move us toward an even more complete elimination of the projected deficits thereafter.

What matters is not so much which way of cutting back will finally be chosen. What is important is that the deficits are dealt with forthwith; that no expenditures -- not even defense -- are exempted from a general belt tightening; that the large, multi-year individual tax cuts are reduced and/or postponed at least for FY'83 and FY'84; and that whatever action is taken involves a just balancing of the burden for all concerned.

Mr. Chairman, we face difficult times. The responsibility resting on your shoulders is great. If you and your colleagues show the courage and wisdom required, I have no doubt that the future health of our economy and the welfare of all of our citizens will be assured.

Budget authority for defense spending would rise even faster, i.e by 86% over the same four year period. Its growth in FY'83 over FY'82 is projected at an unprecedented 21%, or approximately 13-14% inflation-adjusted.

Mr. Chairman, these increases are untenable. The need to strengthen our defenses is clear, but a build-up so rapid as to undermine our basic economy is not. I am not a defense expert, Mr. Chairman, but I do know this: a strong America must be economically sound as well as militarily prepared. That requires a program of slower build-up and greater balance, so that added expenditures for defense can be applied wisely and related more sensibly to what we can afford.

If the increase in defense outlays and authority were kept at 6-7% in real terms over the period FY'83-'85, it would still constitute a substantial rise in the resources being directed toward strengthening our weapons programs. On the other hand, a rough calculation indicates that this could save 12 to 15 billion dollars in defense outlays for FY'83, 16 billion dollars in FY'84, and as much as 25 billion dollars in FY'85. The total savings over the same three year period would amount to at least 50-60 billion dollars, thus greatly easing the budget pressures presently confronting us.

Unfortunately, Mr. Chairman, lowering the increase in defense spending will not suffice. It will also be necessary to look for additional revenues through selective increases in taxes and/or postponement or cancellation of some of the cuts enacted in the Economic Recovery Tax Act of 1981. Indeed, it is clear that a major reason for our present difficulties arises from several ill-conceived provisions of that legislation. Mr. Chairman, in all honesty, I must tell you that I feel strongly that certain features of the 1981 Tax Act were just plain wrong and must be corrected if stability and the prospect of growth is to be restored. The sooner reality is faced in this regard, the better off we will be.

Until the 1981 Act, it had been normal to target roughly one-quarter to one-third of the revenue loss of tax reduction legislation toward the business sector. The 1981 Act broke with this tradition: 28% of the revenue loss will go to business this year, but the proportion will drop to 20% and 18.8% in FY'83 and FY'84 respectively. Given the need for accelerating business investment and growth in productivity, I consider this the first mistake of the Act.

Secondly, it is the three-year commitment to massive tax reductions for individual taxpayers which lies at the heart of the current prospects for huge deficits in FY'83 and FY'84. That is the Act's second flaw.

Third, the Congress saw fit to provide for automatic indexing of income tax brackets, zero bracket amount and personal exemption for increases in the consumer price index. Such indexing robs the Congress of flexibility in the use of fiscal policy as one of the key tools for economic management. It tends to lock in inflation, rather than to deal with it. And it places the kind of undue burden on monetary policy as an economic management tool which, over the last year, has led to the excessively high interest rates from which the economy continues to suffer to the present day. Indexing was the third major mistake in the 1981 Tax Act.

I would strongly urge, Mr. Chairman, that this Committee review these provisions of the 1981 Act and make the corrections which the experience of recent months would seem to indicate. My thoughts in this regard are as follows:

First, given the relatively limited proportion of the revenue loss going to business, I would leave as much of these reductions intact as possible. Most of them relate to the new Capital Cost Recovery Provisions and are designed to increase cash flow and to accelerate replacement and modernization of our physical plant. It is important that this program and the related tax credits for incremental R & D expenditures be carried forward. The business tax cuts, in general, are a key to the future health and growth of the economy. They should be retained.

Chairman ROSTENKOWSKI. Thank you. Mr. Blumenthal, last year, the present administration painted some very rosy pictures regarding where the economy was going; what investment would be made. We were told that the private sector would accept the responsibilities that the governmental sector relinquished.

What do you envision if we do not change our course and if we do not reduce the deficits? What do you envision our international posture will be? How do you feel our trading partners, our allies, and the rest of the world, will look upon the direction of our economy?

Mr. BLUMENTHAL. Well, I think there are two or three immediate effects. And I know that just very recently, Chancellor Schmidt of West Germany has expressed himself in part along these lines. In the first place, we are still the world's largest market and the largest individual trading Nation in the world, although the Japanese are coming up fast. Clearly, the kind of deep recession that we have in this country has an impact and is exported to other areas that trade with us.

So, first of all, it results in a decrease of economic activity elsewhere and has the same weakening effect on our allies and trading partners as it has on us. Second, with these large deficit interest rates, as I have stated, in my judgment will remain high. There is no other explanation but that the markets and the people who make these decisions in the markets simply cannot believe that we can get out of our problem with these kind of deficits. The risk premiums, the risks of sudden change, under these unsustainable conditions are high, therefore, and interest rates will stay high. If that happens, it raises interest rates in other countries, in Europe in particular.

Otherwise you have a huge outflow of funds into the United States. It incidentally raises the value of the dollar, against the currencies of other countries. This is kind of ironic, because remember, Mr. Chairman, when I was in the Treasury, most of our concerns were about the dollar going in the other direction. The dollar was sliding down too low. Well, it has been going up too fast.

I should add that for my company, that cost our shareholders a dollar a share in earnings last year. It means that interest rates in other countries must stay high, which further suppresses economic activity in those countries.

Really what we are doing, since we are the center of the free trading world, we are exporting the problems we face in our own country to other areas. I think the risk that under those circumstances our own problem situations, whether it is a Chrysler or an International Harvester or a bank or savings and loan or a thrift institution that gets into difficulty are repeated in other parts of the world. My real fear is that under those circumstances a set of events can start which can lead to real difficulty for all of us.

Chairman ROSTENKOWSKI. What is your explanation, Mike, as to why there was not the immediate investment response that was forecast? In your opinion, what kept the business community apprehensive? Why has the private sector not accepted its responsibility and invested?

Mr. BLUMENTHAL. Mr. Chairman, I think the business community welcomed with open arms the Reagan administration. I guess

that is not an extravagant statement. They had not been violently enthusiastic about the Carter administration. They were delighted with the program that the President announced, and that was presented to the Congress. But the problem, I believe, became clear rather quickly in that the numbers did not hang together.

The assumptions about growth, about inflation, and about the deficit were not believable from the beginning. Last fall I wrote a piece in Business Week, Mr. Chairman. This was some weeks before Mr. Stockman, I found, expressed himself similarly or at least was reported to have expressed himself similarly in a national magazine. And what I was saying was what a lot of other economists were really saying also. The numbers did not hang together.

So, businessmen while they are fully behind the emphasis on investment and on the reduction of spending, which is very important, could see that we would either have a very large deficit problem, or that the growth would not occur in the way it should, or that the prediction that there would be no serious recession was unbelievable. And all of that caused them to hold back. Businessmen are not economists, but they are practical people and they could see all that. And so, the hesitation I think is understandable. And unfortunately, the evidence bears out their fears, because we are in a recession, we are faced with huge deficits. And the prediction that everything would come out all right because substantial multiyear tax cuts for individuals would somehow so unleash the genius of the American people that we would make up these revenue losses from large tax cuts on the quantity, so to speak, just simply has not been borne out in fact.

Chairman ROSTENKOWSKI. Mr. Pickle will inquire.

Mr. PICKLE. Mr. Secretary, it's good to see you, and we welcome you back. You have given us some frightening testimony, but it comes from a man who is highly accepted as a leader of business in this country, and particularly as one who has served ably the United States as Secretary of the Treasury.

So we don't take your testimony lightly. I find much of your testimony to be in agreement with my own concerns. I listened to your testimony carefully. I want to ask you, I am a little disturbed, though, about page 7 of your statement.

You point out some of the things we did wrong. The first point you made was that one-quarter to one-third of the revenue loss normally would go toward the business sector.

Mr. BLUMENTHAL. Right.

Mr. PICKLE. You said in the first year it would be 28 percent, and then that proportion would drop to 20 and 18 percent.

Mr. BLUMENTHAL. Right.

Mr. PICKLE. Now are you saying that in the tax bill we passed last year, we did not do enough for business?

Mr. BLUMENTHAL. Indeed, I am saying that. I am saying that——

Mr. PICKLE. Let me get my seat rearranged up here, because you are the first one who said we didn't do enough. Most of the criticism is that we have done way too much. Can you tell me why?

Mr. BLUMENTHAL. I am suggesting that a tax bill that has very large multiyear revenue losses for the Treasury, 80 or 82 percent of which go to the individual taxpayers rather than to business when

it is business that needs to have the cash flow to invest and to modernize, that that is an error.

Mr. PICKLE. For my own concern and interest, what should we, or could we have given to business that we didn't give them last year?

Mr. BLUMENTHAL. Well, of course, I am suggesting that maybe you know, there are two ways of looking at that: One, you give business more, or two, you give individual taxpayers somewhat less. That is another way of correcting the relative proportions.

I guess I am suggesting in my testimony that these very, very large deficits that we are having are due to the large revenue losses to the Treasury, most of which go to individual taxpayers. So——

Mr. PICKLE. In essence, do you have a specific recommendation, or are you thinking in terms that the percentages ought to be less for individuals and more for businesses?

Mr. BLUMENTHAL. I am just making the general point, Mr. Pickle, that the tax bill was somewhat unbalanced in that in a situation where we need to modernize our plant and equipment, it made large multiyear tax cuts to individual taxpayers, incidentally, on a basis which gave a lot to high-income people, but that is a different issue again.

Mr. PICKLE. I want to ask you a question. My time is not all gone, so let me indulge in a little bit of philosophy with you. You express strong concern that our deficits are horrendous. And we cannot sustain $100 to $150 billion deficit. That it is psychological as well as factual, goes to the heart of our problem.

So we must reduce the deficit to get the interest rates down. And we must come nearer a balanced budget. You have come to the conclusion that some kind of a required constitutional amendment may be the only vehicle that will keep us in line.

But what is interesting me in recent days, since I have come back from my district, is that a lot of people think we ought to do something specifically to retire the national debt, that there ought to be a vehicle for it, that we just can't let it ride, because eventually it is going to get higher and higher.

I have three or four suggestions made to me in my district last week that we ought to set up a mechanism to retire the national debt, even to the extent of allowing an individual to buy a Government bond, 2 percent of it on a set period of time, for a year. Have you given any thought to some way to retire the national debt, even currently? Currently we are experiencing great difficulties, but how and when do we address that problem? Is that important?

Mr. BLUMENTHAL. You know, you cannot do what we do in business, which is just to write it off. It is not that simple. I think what is more important is that we show the country and we show the world that we are not adding to it.

To retire it and start all over again, even if it could be done, would not really help us a great deal. What we have to do is bring receipts and expenditures into better alinement. If we did that and had that, that would be my first priority.

If we had done that, then I think we can begin to deal with questions, whether the Government financing that is being used by the Treasury is the right approach. There have been suggestions of dif-

ferent kinds of instruments, debt instruments that the Treasury might issue which would help that situation.

I guess my conclusion is that it is not a first priority issue to deal with what has already happened, but the first priority is to deal with what we are now confronting and what is going to happen if we don't take action.

Mr. PICKLE. It would be interesting to see what we do. It may not be a first priority but I have about decided that it is going to become a higher priority. Perhaps it is high time it does. Thank you, Mr. Secretary.

Chairman ROSTENKOWSKI. Mr. Anthony will inquire.

Mr. ANTHONY. Thank you, Mr. Chairman.

Mr. Blumenthal, I would like to thank you for many of the comments that you have put into your statement. I think that you have really zeroed in on the sensitive areas and the political areas.

If you get some of the Members of Congress back in the cloakroom, they will agree with you in private that some of the things that you have said need to be done.

One of the ones that I mention specifically is the reduction of the COLA increase in social security. I dare say if you took a private poll, you would probably get 85 percent of the Members of Congress saying it ought to be done. You probably couldn't get 10 percent to go out and vote yes for it if we had to vote on it tomorrow. So I think you have really zeroed in on probably some of the difficulties we have with this.

I want to ask you some questions about fairness, because you have zeroed in on the fairness question in your testimony. Yet you say that the only thing that needs to be taken away on the tax side is from personal individual tax cuts. With the exception of saying some loopholes need to be closed for corporations, you don't really hang out any hopes that business would be willing to share in part of the burden of this tax revenue increase.

How would I sell your particular proposal if I went to south Arkansas and said that we were going to eliminate the personal income tax cut in 1983, 1984, and knock out indexing; we would increase energy taxes, we would knock out social security increases, and I would also eliminate certain agricultural subsidies, yet I would keep intact all of the business cuts.

Now, I am going to have a hard time selling that. What is your explanation if you are on the stump down in my neck of the woods?

Mr. BLUMENTHAL. Well, I think this is a very good question, sir. What I tried to do is to in fact acknowledge that you ladies and gentlemen are going to have a very difficult political issue on your hands. I recognize that. And I appeal to you to grasp that nettle. I realize that the only way to do it is to have a package deal in which you can say that everybody chips in.

Let me make the point that the way to get out of the situation that we are in is to find a way to make the total pie grow, and for us to make the total pie grow, the economy being the total pie, so that we each have bigger pieces. This means that we all have to sacrifice in the beginning so that that pie can grow.

So what I tried to say was, first of all, something out of defense. That is one area we can take.

Second, something cut of these entitlement programs and the overindexation of social security and pensions. That is the second. You couldn't do that alone, but as part of a package deal.

Third, on the tax side, stretch out, if necessary, defer some of the individual tax cuts. And I have not commented on but I will be glad to, well, and I have not said anything about business because I made the point that business actually got relatively less in the 1981 act than as usual. But if you wish——

Mr. ANTHONY. Could I ask a question there? We hear all of these stories, some people refer to them as horror stories about the leasing provisions and how abused they appear to be. Now, in more recent publications we are reading about the capital cost recovery and the fact that there is actually going to be a negative tax because of some of the implications of that particular tax provision.

Again, how am I going to sell it to the average guy in my district that is making $10,000 and $12,000 a year, and he is going to read where Occidental Petroleum is not paying any taxes. He is also going to read where it appears now that some of these other manufacturing facilities are going to actually have a negative tax burden.

Yet he knows that he is paying on a withholding basis, and he doesn't have the ability and flexibility to shift it around and to save taxes.

Mr. BLUMENTHAL. Well, the administration has proposed a range of loophole-closing actions which will reduce——

Mr. ANTHONY. That is going to be my last question. I want to get a yes or no from you.

Mr. BLUMENTHAL. Well, the answer is yes. There should be added something that reduces some benefits for business. I would deal with these loopholes. I have looked at the numbers here. From what the administration has proposed in the way of reductions in cuts, or rather increases in revenue, a large portion is actually targeted on business, the minimum tax.

Mr. ANTHONY. Are you for or against?

Mr. BLUMENTHAL. I think under the circumstances that is a reasonable provision. So, there are measures that ought to be taken, I agree with you, so that you can tell your constituents quite properly it is a package deal.

Mr. ANTHONY. What about withholding on interest and dividends?

Mr. BLUMENTHAL. I felt as Secretary that that is reasonable. I must say that if you can get that through the Congress, I would jump up and down with joy and cheer, but I doubt——

Mr. ANTHONY. You would support it personally?

Mr. BLUMENTHAL. Oh, I would support it, yes, I would support it.

Mr. ANTHONY. What about the corporate income tax payment speedup?

Mr. BLUMENTHAL. Well, if you want to have a package deal and you could do all these other things, while I can't speak for them, I would suspect that my colleagues in the business community would swallow that pill and say, "Well, it is part of an overall deal, but we are getting the budget under control."

In and of itself it is just a way of increasing taxes for the business community, but if that is part of an overall package and you could do all these other things, I think there is something there.

I do want to make this point, though, because I think it is important. Of the increases in revenue that are being suggested in the legislation, 70 to 75 percent of those are aimed at the business sector, so that you really have before you, quite apart from what happened in 1981, a way of picking and choosing some provisions, like the minimum tax and others.

There is this modified coinsurance and a number of other things which you could do, which would allow business to pay its fair share of that package.

Mr. ANTHONY. Would you be for or against the restriction of the tax exempt bonds?

Mr. BLUMENTHAL. Well, I remember that one from my Treasury days. That has been abused at times, and I think that ought to be tightened up. I haven't followed it closely.

Mr. ANTHONY. What about repealing of the business energy tax credits?

Mr. BLUMENTHAL. I don't know enough about that.

Mr. ANTHONY. What about the modified coinsurance?

Mr. BLUMENTHAL. Well, I think some action can be taken there, yes.

Mr. ANTHONY. Capitalization of construction period, interest, and taxes?

Mr. BLUMENTHAL. I don't know that one well enough.

Mr. ANTHONY. So basically what you are saying as a businessman is that if the congress can package a total approach to trying to overcome what you consider to be a totally unrealistic, unmanageable, unworkable budget that has been presented by the administration, then you as one businessman would be willing to encourage the entire business community to accept that?

Mr. BLUMENTHAL. I would say go easy on the business sector. You weren't that generous with us in the 1981 act. That is where the investment is required if this pie is going to grow.

Mr. ANTHONY. You said something that struck home with me. That was the psychological factor of what was happening and the uncertainty created. Let me say that psychological turns into political when I go home and try to sell a package when I can't say the individual taxpayer is being treated fairly with business.

I can tell you right now we have an uphill fight when it comes to talking about leasing and some of these other provisions. Many times we don't have time to educate every single person in our district.

Mr. RANGEL. I am shocked to hear you say you don't think this Congress was generous to business. Are you concerned with the proportion of the tax giveaway?

Mr. BLUMENTHAL. I am concerned. Yes, I am certainly not arguing that ACRS was not a good and generous provision. That is not the issue, Mr. Rangel. The issue is that I am really surprised that a conservative Republican administration proposed and the Congress agreed to a tax bill which broke tradition and gave a lower percentage of the total revenue loss to the Treasury to business than

previous liberal Democratic administrations ever did propose and enact. That is what I am referring to.

Mr. RANGEL. Well, are you concerned with just the percentages and how they were allocated. What difference would it make if you got more than you would have anyway?

Mr. BLUMENTHAL. I guess I am not a supply sider, Mr. Rangel. I am saying that to get this economy moving, to make the pie grow, to make the economy grow, to get inflation out of the system requires investments in the future. Investments in the future, in my judgment, require the business community to have the cash flow to invest in the future for productivity increases, for R. & D., for those sorts of things.

Mr. RANGEL. Would that have shifted if we had given the individual taxpayer less?

Mr. BLUMENTHAL. If you had given the business community, if you had given businessmen more incentives to create jobs and to do these sorts of things——

Mr. RANGEL. No, I am saying if we had given the individual taxpayer less and left the business sector alone that the percentage would have shifted toward business. That wouldn't have helped much.

Mr. BLUMENTHAL. I am saying if you were willing to give that much revenue away, you should have given it to business rather than to people who would spend it. We should have invested more in the future.

Mr. RANGEL. Isn't it true there has been a percentage in the shift of revenues raised from the corporations to the individual taxholders?

Mr. BLUMENTHAL. Oh, very much so, very much so. When you look at the proportion over the years, the proportion of tax revenue coming from—here it is. Well, actually the individual taxes by 1984 will bring in about 44.7 percent of the budget I see here. Corporations are going up now from 7.5 percent to 11.6. Of course, the social security and insurance taxes are going up from 30 to 33.5 percent. Meanwhile, the State and gift taxes and others are going down.

Mr. RANGEL. How much more, Mr. Secretary, can we give businesses without paying them to stay in business? Where would we give? They pay taxes anyway in the corporate world. I understood that some people were ashamed that they did not have tax liability.

Mr. BLUMENTHAL. I am not arguing for zero tax liability.

Mr. RANGEL. Some have.

Mr. BLUMENTHAL. You can correct that. I would not feel bad about that at all. You could deal with that problem. I am talking about the tens of thousands of companies who need to invest, who need to do research, who need to build new plants and equipment and who need the cash flow. That investment in the future rather than consumption is what creates jobs and makes the country more productive.

Mr. RANGEL. I gather from your testimony that you thought the House was just as irresponsible as the Senate in writing the tax bill.

Mr. BLUMENTHAL. I think it became a bidding contest between the administration and my party in which either version it would pass was a bad version.

Mr. RANGEL. What role do you think responsible businessmen played in this bidding?

Mr. BLUMENTHAL. Responsible businessmen—I think the business community as a whole took the right position, which was to indicate that major incentives for business to invest were required. And beyond that, I do not think that they had any particular role to play.

Mr. RANGEL. They supported that package which you were critical of in toto. They went so far as to say that if we looked at any part of it with a critical eye, it would unravel.

Mr. BLUMENTHAL. I think there was a period a year ago when the general enthusiasm for the new administration created a situation when nobody looked critically at the components.

Mr. RANGEL. I think the same thing applied to the Senate and House Members. It appears they were swept away by the popularity of the President rather than the substance of his package. Do you expect the business community to be any different this time out?

Mr. BLUMENTHAL. I am speaking for myself, although I am a member of all the major organizations, I guess. I would say that in talking to my business colleagues, chief executives of other companies, and some of the distinguished ones will be testifying today, my impression is that there is a growing concern about the deficit, and I think that you will find, if I can be so presumptious, you will find a fair measure of agreement among businessmen about the proposition that the deficit has to come down, that everyone can play a major role if given the resources to modernize our plant and equipment and to make the economy grow. That is my proposition.

Chairman ROSTENKOWSKI. Mr. Matsui will inquire.

Mr. MATSUI. Thank you.

Mr. Secretary, you are the chief executive officer of Burroughs Corp., and on boards of a number of different corporations in the United States. Since we have passed the accelerated depreciation cuts along with other business cuts last July and signed by the President in August, has your company changed its pattern in terms of investments for retooling as you have mentioned? Have you increased that for the next 2 or 3 years?

Mr. BLUMENTHAL. I think, Mr. Matsui, we are in some sense in the same position as business generally. We have seen the continuation of very high interest rates, which I ascribe personally to the prospect of continuing high deficits, and the preemption by the Treasury in the capital markets of a large portion of the investment funds available, so we have not really been able to go into the capital markets in the way in which we wish. For example, my company has too much of its debt in the short term. We really need to re-fund the debt. There is no way to do that. The markets are closed. We cannot go out and sell equity, common stock equity, on the present basis because the whole stock market is so depressed that we are selling substantially below book. So that is not a possibility.

As to Burroughs, particularly the ACRS provision has actually resulted in increased tax liability at least until 1985, and under the old system we would have had a benefit. We will have a benefit as of 1985, and there are some investment tax credit provisions which help us so we are a little on the negative and roughly neutral for the next couple of years, and then we will benefit.

Mr. MATSUI. Most of the business people that I have spoken with are saying now that the high interest rates actually have taken away or eliminated all of the value of the business cuts that we instituted last year, and to some extent in order to balance the budget or reduce the deficit we will have to take a look at those business cuts again. I guess the question we want to pose is do we want to have high interest rates or do we want to have the business tax cuts. It may be a choice between the two if the President is going to obstinately continue not talking about the defense budget.

Mr. BLUMENTHAL. I would hope that the Congress, working with the administration——

Mr. MATSUI. I think it would be the administration working with the Congress. We are willing to work with him, but he does not seem to want to work with us.

Mr. BLUMENTHAL. I have a lot of faith in President Reagan. I am sure he will come around to seeing the need for this. If you are looking for ways to improve the situation for business you might on ACRS, taking note of the fact that for some companies such as my own, it actually results in a negative in the early years, gives us the choice of applying either the old or the new provisions. We would have a more immediate benefit rather than waiting until you are at 200 percent.

Mr. MATSUI. Let me ask you one more line of questions, if I may. Under the prior depreciation standards we had before July of last year, the disparity between the effective tax rates, between the different investments was about 28 percent . I think the range was 53 and 25 percent, somewhere in that range. Under the new proposal that was passed in July of last year, you have a negative of 11 percent for automobiles, for an effective tax rate all the way up to 37 percent for some labor-intensive industries, which is a 48-percent spread. Do you think that is going to lead to inefficient investments, and if so would you propose making some changes within that spread, not so much to take away any of the tax cuts, but make some changes within that spread itself?

Mr. BLUMENTHAL. Well, I think it has been generally known that accelerated depreciation formuli have a different impact on different industries, depending on the degree to which they are capital intensive, and have either fast- or slow-depreciating assets. That is a natural consequence of using that approach. I think there are ways of improving it, but I do not think it is such a serious problem. Everybody benefits substantially, some more than others.

Mr. MATSUI. In other words, whenever you cut taxes for business you are benefiting all the industries and all the companies. Assuming we are going to do that anyway, do you think we should bring more equity in the depreciation schedules to try to make it neutral? When you have a 48-percent spread you will have people investing where they can get the biggest cut, and that does not help

efficiency. Do you think we should make changes in that area in view of the fact that we want efficiency and fairness in the tax system?

Mr. BLUMENTHAL. Yes. Anything you can do to provide not only fairness but also the incentives for industry to make the investments where they are most needed and to provide the cash flow where it will lead most quickly to increases in productivity is a desirable change.

Mr. MATSUI. You would support this committee reexamining the accelerated depreciation part of the tax cut to try to make it more equitable?

Mr. BLUMENTHAL. It is not your biggest priority, but if you want to do that and you can find a way of making it more equitable and providing fairer incentives to business where needed, I think it is worth looking at.

Mr. MATSUI. Thank you.

Chairman ROSTENKOWSKI. Mr. Gephardt will inquire.

Mr. GEPHARDT. It is a pleasure to hear your testimony. I would like to do two things to better understand what you are saying about budget deficits. It is always hard to really get down to the nub of what they do to the marketplace, and as you say in your testimony, the significance of the deficits are psychological as much as they are substantive. Let me try to understand a little more fully what you mean. I think the crowding out phenomenon is well understood, especially in a time when the economy is trying to pull out of a recession, which is hopefully what we will soon do. But is not the crowding-out phenomenon directly related to the psychological phenomenon?

In other words, the crowding out, if I understand it correctly, has a direct quick impact on short-term interest rates, and if that prime rate jumps up and is very visible and in the newspapers, that in turn probably has a deep psychological effect on the long-term markets, on the bond markets, on the equity markets, et cetera, is that not true? Is that not the most visible thing that happens, and is that not the most related substantive thing that happens?

Mr. BLUMENTHAL. I think perhaps one way of putting it, Mr. Gephardt, is to say the impact of high deficits comes in two areas: one, what actually is happening, and second, what people think will happen. And what I am saying is what people think will happen has as much of an impact on their actions today as what actually has happened today, which then affects their action.

Mr. GEPHARDT. It seems to me that if people feel, for example, that a very large deficit is untenable, that the economy will sink deeper into recession, and that sooner or later Mr. Volcker is going to have to ease up or the Congress is going to have to pass legislation to have that same effect of one kind or another. That uncertainty, for example, will keep interest rates high because it increases the risk.

One of the explanations for the present high real rates of interest in the markets is that it represents the risk premium that investors assigned to the uncertainty of future policy created by the present program. It is ironic, it seems to me, that President Reagan quite correctly started out by saying there must be certain econom-

ic policies, we must be certain what is going to happen, we must be sure that businessmen and investors know what the future holds. He has tenaciously held onto his program, yet by doing so he has created uncertainty about the future.

Mr. BLUMENTHAL. It seems to me that one can theorize in economics—I have a number of degrees in economics, although I am trying to live that down—and one can theorize about anything in economics, I can explain anything to you in terms of economic theory, but theory is theory and fact is fact, and conditions have changed so much in the country.

One thing I used to tell the President was: Hear the theories, listen to the theories, and forget them and use your gut feel. Because things change so much that people react differently than they used to, and that different action among the people has much to do with the high inflation we have had in the past. People are scared of that. They have learned we can have 20-percent interest rates, that you are no longer safe, and that therefore the high deficit is a symbol of that and that creates a kind of problem. And of course the very high interest rates in turn cause people immediately to hold back and not to make the investments and act in economically rational ways. They buy raw land or speculate and buy gold. All of these things keep our productivity down, and therefore I think you have to have a program that shows that the Federal budget is under control.

Mr. GEPHARDT. And that hopefully if it creates that expectation and that begins to embed itself——

Mr. BLUMENTHAL. Right.

Mr. GEPHARDT [continuing]. That there will be a stable path, and hopefully over a period of time you can change the psychological expectation?

Mr. BLUMENTHAL. You would, very quickly. I think that if this Congress together with the administration can enact a program that believably—and I mean believably, because these assumptions are not good assumptions—believably reduce the deficit in the range of $50 billion or $60 billion and show a hope of it declining—you do not have to show balance, but show hope of it declining in the next 2 or 3 years—those markets would take off. But unless you are able to do that, people—some of them may not say it publicly, but people are going to sit back and be scared.

Chairman ROSTENKOWSKI. Would the gentleman yield?

Mr. GEPHARDT. Yes.

Chairman ROSTENKOWSKI. Mr. Secretary, you are talking about working together with this administration. We went through that drill. We tried. Since the enactment of last year's tax reduction act, I think a great many people have agreed that we were a lot more flexible. The administration now suggests that we should come up with our own alternatives—but do not touch the tax cut for individuals—do not touch defense spending.

The President is a man that tenaciously hangs on to his position. Where is there ground for compromise? Should Congress tolerate being restricted only to specific areas when coming up with alternative proposals? That is not the way I like to bargain.

Mr. BLUMENTHAL. I understand. Mr. Chairman, I have listened to the President's press conference yesterday carefully and read all

his statements. I have read Mr. Stockman's testimony. It is only February. It is urgent, but I think there are a few glimmers of hope here and there that maybe the position is not so rigid, and as I think the accumulating weight of testimony, not just from former Democratic Secretaries of the Treasury like myself but others, including people from his own party, show that you cannot bring the deficit down without dealing with defense there will be the opportunity for some compromise, I hope. You just have to keep working at it.

Chairman ROSTENKOWSKI. I recognize from the minority leader in the House that some winds may be changing that this is their first volley—that the administration will talk to us. We had that first volley about 12 months ago. Then, a third bargaining agent emerged. As soon as it became apparent that they had the horses, the rest of us were disqualified. So I think what you have to accept is a little apprehension on the part of the Chair as to how serious the administration is in reaching an agreement. I do not think for 1 minute that it can be suggested to us in the legislative branch that a certain area cannot be touched.

Mr. GEPHARDT. That is fine. That is very relevant to what I wanted to get to. I really think that what you have got in your testimony about changes in the taxes is where the heart of this negotiation if it occurs will go on, and I think the chairman of this committee and the members of this committee as we were involved in it last year to no avail will be deeply involved in it this year, and I think the chairman is absolutely correct in noting that so far it does not look like we can even begin the negotiation. If we get to that point, let me talk about the detail, because it is on the things you hit here that the deal will have to be struck.

Let me first talk about tax increases other than fooling with the individual cut, because it would appear that may be the easiest place to go. You say here that we ought to look at energy taxes and excise taxes. Obviously the President looked at those in the last 2 months and decided against them at the 11th hour. Do you really think that that is a good way to go if we cannot go back on the individual cut, should we raise and can you get enough out of beer and cigarette taxes and excise taxes and energy taxes, and would that create the economic effect that you want?

Mr. BLUMENTHAL. I would look at the energy side first, actually, because even though we have been a great deal more successful than many people assumed with conservation and reducing the need to import oil, some of it having to do with the current low level of economic activity, this is a problem that will be with us for a long period of time, and anything that can be done to stimulate exploration and production in this country and to keep wasteful consumption down I think is a good thing. Therefore such areas as decontrol and some taxes relating thereto I think would be a good thing.

Let me suggest one political point. You are the politicians. Fortunately I am not and thus do not have as difficult a problem as you do. But it seems to me that what is so terribly disturbing is not only the high unemployment in areas such as my own and perhaps in your States, but also the impact of the high rate of interest on young families who try to buy houses. It is just impossible. You

know the stories, and you know it in your own families. It seems to me that if somehow the people of this country can be told how very high interest rates have impacted them and how jobs have been lost because of that. If interest rates can be reduced, if the process can be reversed through some stretchout in taxes it would create jobs. They are losing more with the high interest rates than they are gaining from some of these promised income tax reductions. I think you would find a fair level of support from that. That connection has to be made.

My children, who just got married and want to buy a house and cannot, understand that. The few bucks they get in income tax reduction, $800 a year, do not weigh heavily on the balance of going out and finding that you cannot get a mortgage or that you have to pay 18 percent for a mortgage. If you make that connection I think it is not such a bad political basis to explain to people why everybody has to make a contribution or why some energy taxes may have to go up.

Mr. GEPHARDT. For 1983 we cannot get a lot of money in terms of revenue unless we do the kinds of excise taxes you suggested, which as you know are hard to do politically, and decontrol of natural gas is difficult when you have the kind of weather conditions you have and the bills going up anyway under the present decontrol path. So that brings you back to the individual tax cut, and I realize the President has said it is not negotiable, but let us talk about that for a minute. You suggested that we might think about dropping the 1983 cut and we should not fool with the 1982 cut. If you are to get a lower deficit in fiscal year 1983, you have got to do something with the 1982 cut, because most of fiscal year 1983 would be affected by that, and not by the July 1983 cut. On that point, two things you can do, one you can increase that cut for this year and even start it earlier and then drop it off at the end of the year, which would have a big 1983 impact, or you can reduce it to 7 or 5 or whatever and then let it go and then fool with 1983.

Does either of those make any sense?

Mr. BLUMENTHAL. I prefer the former. I think in 1982 we are dead anyway. I think we are in a deep enough recession that it is important to let a greater additional cut go forward. But then the prospect of a substantial move toward reducing the deficit in 1983, and beyond would be helpful. So I prefer the former.

Mr. GEPHARDT. A question on indexing. You come out against it. Others lately have been saying, even tax reformers have been saying that tax indexing is not a bad idea because it keeps you from doing all the crazy increments of deductions and preferences that we have engrafted on the code through the years. I am wondering, what is your main basic objection to continuing indexing?

Mr. BLUMENTHAL. My main basic objection to indexing is really twofold. One, I am a firm believer that the management of macroeconomic decisionmaking must involve fiscal and monetary policy working in concert and being changed and adjusted depending on conditions at any one time over a period of time. There has to be a balance between those two. To the extent to which you have an automatic reduction in tax brackets in an inflationary environment, you rob yourself of the flexibility of the use of fiscal policy, and you put too much pressure on monetary policy. Second, I am

very much influenced by the experience with indexing in all of the countries that have had high levels of inflation. I remember the Foreign Minister of Brazil saying if there is one thing you must do if you want to lick inflation in your country, it is fight indexing, because you have tied one hand behind your back when you have this. Keep that flexibility for yourself. So the second reason is that under indexing people lose the incentive to deal with inflation because they say, "Well, it is indexed anyway." Once you index income tax rates, the argument for not indexing all the other payments and receipts in the country becomes less powerful. Then every insurance company wants to index the money it lends and we start indexing dividends and so forth.

If we do it automatically we will have this inflationary thing forever and we lose control of getting it out of the system. And there are many people who will be hurt by inflation. I will not be hurt. Maybe congressional salaries will not be hurt, I do not know, but some people will be hurt, and that is bad.

Mr. GEPHARDT. Thank you very much.

Chairman ROSTENKOWSKI. If there are no further questions, Mr. Blumenthal, we appreciate your time and the testimony that you have presented. Thank you very much.

Mr. BLUMENTHAL. Good luck to you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Beach, Mr. Beck, Mr. Evans, and Mr. Walker. Welcome, gentlemen, to the committee. It is gratifying for us to have you appear. We look forward to your testimony. In most instances, I have read some of it already.

Before you begin, I want to apologize that I have to withdraw for 15 or 20 minutes, but I shall return. In the meantime, Mr. Pickle will chair the committee.

We look forward to a lively discussion immediately after your testimony. As is our custom, we will have each of you make your presentation. Then, we will permit exchanges between the members of the committee and the panelists.

Mr. Beach, if you would like to begin, the committee is ready to receive your testimony.

STATEMENT OF MORRISON H. BEACH, CHAIRMAN OF THE EXECUTIVE COMMITTEE, TRAVELERS INSURANCE COS.

Mr. BEACH. Thank you.

Mr. Chairman and members of the committee, I am Morrison Beach, chairman of the executive committee of the Travelers Insurance Cos. I am pleased to be with you today to discuss the administration's economic program and the difficult and critical policy options you confront in pursuit of a goal we all share: The speediest possible return to conditions of healthy economic growth and full employment.

With the committee's permission, I would like to submit a long statement for the record, and to summarize my remarks.

Mr. PICKLE [presiding]. Your entire statement will be included in the record, Mr. Beach.

Mr. BEACH. A year ago, the subject of inflation dominated the Nation's headlines, as well as congressional hearings such as this one. Since then, the inflation rate has been significantly reduced.

Indications are that it will continue to decline—perhaps to as low a level as 7 percent by 1983.

This is a greater and more rapid reduction than anyone could reasonably have predicted. And it is a substantial achievement. And it is one that improves the well-being of many members of our society least able to protect themselves, such as the elderly living on fixed incomes, but is also somewhat at the expense of some who are unemployed.

Today, we have a replacement for inflation as the subject of economic preoccupation: the size of the Federal deficit and its impact on interest rates. I am very concerned about the magnitude of the Federal deficit—indeed critically concerned about projections that the deficit could remain high over the foreseeable future.

But my message to you today is not to let our concern with this year's deficit unduly distort our thinking about the economy. It should not obscure the real accomplishments that have already been achieved. Nor should it induce a premature departure from the principles of the tax and expenditures policies that are fundamentally sound and have not yet had a chance to work.

The thrust of the administration's budget policy last year was unquestionably in the right direction: To foster levels of savings and investment necessary to increase productivity. The top priority for this country must be to improve the productivity of our economy, expand employment, and make our products and services more competitive in world as well as local markets.

The centerpiece of the administration's policy is reduction of the burden the Federal Government imposes on the economy and its productivity. The administration confronted an economy in which the rate of increase in Federal expenditures and the rate of increase in Federal tax revenues were both accelerating. At the same time, the rate of personal savings had declined to ominously low levels.

The administration responded forcefully and directly to these conditions:

Business taxes were reduced in a way to encourage new investments.

Personal tax reductions included specific incentives to save and invest.

And increased emphasis was placed on the cost-benefit ratio of regulations.

All were steps in the right direction, but concerns are already being expressed that the programs are not working. The expected level of job-creating investments has not materialized yet; we are faced with a succession of disturbingly large deficits, and interest rates remain high.

As to new investments, favorable tax policy is not the only factor businessmen have to consider before making investments. The fact that we are in a recession, operating substantially below capacity, and that interest rates remain high, is making it very difficult for businessmen rapidly to take advantage of the new tax incentives.

But the problems created by large deficits and high interest rates will not be solved by reversing recent tax policy.

Admittedly, interest rates are high because of Government competition in the capital markets and the concern that continuing

large deficits are inevitably inflationary. However, the solution to these problems does not lie in abandoning the recent tax reductions, because a large part of the tax savings will go into investments.

Certainly this is true of the business tax savings. Raising taxes on those who would otherwise save would reduce the deficit, but would also reduce the amount available for investments, and would not reduce interest rates appreciably. This problem can be solved only on the expenditure side.

A strong and healthy economy does require long-term job-creating investments at reasonable interest levels. But we have seen a reduction in the funds available for these very investments:

Life insurance companies—historically a principal source of such funds—because of policy loans and cash surrenders, do not have funds available for long-term, fixed interest investments.

Pensions are concentrating on inflation hedging and not long-term bonds. Inflationary expectations are the principal cause of these developments.

But also, Government long-term borrowing—a third of the private sector's in 1975—is now 50 percent greater than that of the private sector.

This results partly from the Government's "stretching out" the maturities of the debt from an average of 29 months in 1975 to over 4 years now. This policy should be reconsidered.

The comments I have made lead to the following four recommendations:

First, with respect to tax policies, the savings and investment incentives enacted last year should be retained. However, there may be tax loopholes that should be closed and additional sources of tax revenues that can be utilized.

Such tax increases must not, however, have the effect of diminishing savings and investment, or be perceived as a reversal of policy.

Second, the rate of increase in defense spending should be subject to close and careful scrutiny. Few Americans question the need for increased military spending, but some question whether such a rapid increase can be cost effective.

Third, because of recent and prospective tremendous increases in social security benefit payments and the trust fund's current deficit, I believe this program is in need of urgent reform. The Nation now faces both the necessity to correct the short-term imbalance between revenues and obligations, and the opportunity to place the system on a financially sound basis that will function reliably not only for this generation but for future generations as well.

The National Commission on Social Security Reform is scheduled to submit its report by the end of this year. I hope that the Congress will act promptly on the Commission's recommendations.

I want to stress, however, that I do not advocate balancing the budget by cutting social security benefits. But the system must be put on a sound economic basis and be perceived as such by the public. Too many people now do not expect to receive benefits from the system, and that is wrong.

Fourth, the search must continue for further cuts in social programs. But cuts must not be indiscriminate or at the expense of our most powerless citizens.

I don't envy your difficult task to insure that the additional cuts will not come at the expense of the most vulnerable. However, we must not lose sight of the fact that the best way to insure the goals we all share for our social programs is to have a healthy and growing economy.

In conclusion, let me reiterate the importance of consistency and stability in the fiscal policy of the Federal Government. The purpose of the incentives structured into fiscal policy is to influence private spending and investment behavior. But those incentives can only work if they remain intact. There is no point in enacting incentives if the people you want to influence believe those incentives might be repealed soon thereafter.

Deficits—as well as inconsistent policies—damage public confidence and raise inflationary expectations. The projected deficits must receive firm remedial measures. If they continue to rise, the public will know that a massive problem is being postponed and will be uncertain of the eventual remedy the Government will choose.

So it is critical that we continue to reduce the size of the Federal Government's share of our national economy, and that we bring those deficits down. These efforts will demonstrate convincingly that the Government is willing and able to provide a sound political environment in which the economy can grow.

Mr. PICKLE. We thank you, Mr. Beach.

[The prepared statement follows:]

STATEMENT OF MORRISON H. BEACH, CHAIRMAN OF THE EXECUTIVE COMMITTEE, THE TRAVELERS INSURANCE COMPANIES

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INTRODUCTION

A year ago, the subject of inflation dominated the nation's headlines, as well as Congressional hearings such as this one. Since then, the inflation rate has been significantly reduced. Indications are that it will continue to decline—perhaps to as low a level as 7 percent by 1983. This is a greater and more rapid reduction than anyone could reasonably have predicted. It is a substantial achievement. And it is one that improves the well-being of many members of our society least able to protect themselves, such as the elderly living on fixed incomes.

Today, we have a replacement for inflation as the subject of economic preoccupation: the size of the federal deficit. I am very concerned about the magnitude of the federal deficit—indeed critically concerned about projections that the deficit could remain high over the foreseeable future. But my message to you today is not to let our concern with this year's deficit unduly distort our thinking about the economy. It should not obscure the real accomplishments that have already been achieved. Nor should it induce a premature departure from the principles of a tax and expenditures policies that are fundamentally sound and have not yet had a chance to work.

The thrust of the Administration's budget policy last year was unquestionably in the right direction: To foster levels of savings and investment necessary to increase productivity. The utmost priority for this country must be to improve the productiv-

ity of our economy, expand employment, and make our products and services more competitive in world as well as local markets.

Enhanced productivity is essential—not only to restore and maintain healthy economic growth and expand employment opportunities in the eighties, but even more critically, to insure prosperity in the decades that will follow. Then, the economy must meet the challenge of a demographic change unprecedented in our history. We have an aging population; and a declining proportion of workers must be able to support an increasing proportion of retirees. Today, only about 11 percent of the population is over 65; in the year 2025, the elderly will make up more than 18 percent. This challenge can only be met if we have a vigorous and expanding economy. And I firmly believe that the Administration's budget policy has the basic ingredients necessary to produce just such an economy.

THE ADMINISTRATION POLICY

The centerpiece of Administration policy is reduction of the burden the federal government imposes on the economy and its productivity. The Reagan Administration was confronted with an economy in which the rate of increase in federal expenditures and the rate of increase in federal tax revenues were both expanding. At the same time, the rate of personal savings had declined to ominously low levels. The Administration responded forcefully and directly to these unhealthy conditions.

As to the first condition, government expenditures had been rising more rapidly than the economy could support, and showed signs of being increasingly uncontrollable. In fiscal year 1980, for example, federal expenditures increased by more than 17 percent over the previous year while GNP rose only 8.8 percent. Indeed, the Administration has already achieved historic reductions in the growth rate in federal spending. From the 17.4 percent increase in fiscal year 1980 and a 14 percent increase in fiscal year 1981, the Congressional Budget Office estimates only a 12.6 percent increase in fiscal year 1982 and a 9.3 percent increase in fiscal year 1983. And if the Congress enacts the additional budget cuts proposed by the Administration, success in controlling what many have come to view as inevitable annual increases in federal spending would be truly dramatic.

The second dangerous trend the Administration faced was the steadily risir.g tax burden required to pay for the ever-increasing expenditures. Last year, federal income taxes, for example, swallowed 12.3 percent of personal income and employee and employer taxes for social insurance rose to an amount that equalled an additional 8.4 percent of personal income. The response of the Administration was to introduce the 5-10-10 personal income tax cut and to substantially reduce business taxes as well.

The net result of earlier tax increases and persistent inflation, of course, was that personal savings were choked to dangerously low levels. Indeed, we have witnessed a striking decline in the rate of personal saving in the United States: the rate declined nearly 30 percent from 1971-75 to 1976-80. In 1980—despite surveys showing that more than 80 percent of Americans thought it worthwhile to save as much as possible—only 39 percent described themselves as regular savers. This sharp decline in personal savings has dangerous implications for the retirement security of those who save little or none of their income. It is also a direct threat to America's power to build new factories, exploit new technology, and create new jobs in the face of increasingly competitive world markets. The Administration's response here was to introduce various incentives to savings and investment.

THE CURRENT DILEMMA

Despite the adoption of this carefully tailored policy, and despite the positive aspects of recent economic developments—including greatly lowered inflation rates, increased emphasis on the cost-effectiveness of regulations, and a revolutionary shift in the growth rate of federal spending and taxing—today we are all concerned about the size of the federal deficit. We cannot ignore the importance of the deficit—particularly the prospects of it remaining high for much of the remainder of the decade. We must lay down a strategy to bring the deficits down more rapidly over the next few years. But I do not believe that strategy must—or should—include a wholesale abandonment of Administration policies whose fundamentals are sound.

THE DANGERS OF SHIFTS IN BASIC POLICY

If many perceive a readiness to abandon the tax and spending reductions so recently and overwhelmingly enacted, or to alter some of the new savings and investment incentives, individuals and businesses may well defer their savings and invest-

ment plans. Quite simply, they cannot afford to make decisions that hinge on current savings and investment incentives when it appears that those incentives may soon be eliminated or reduced. This is particularly true for projects involving multi-year investments.

I am most concerned with maintaining the form and scope of the recent changes in accelerated depreciation, since this part of the Economic Recovery Tax Act probably most directly promotes business investment. However, I am also concerned over recent proposals to abandon the 5–10–10 personal tax cuts. These proposals arise in part from a perception that personal tax cuts do not directly effect business investment. If the 5–10–10 cut is scaled back, businesses and households will not have the confidence that other tax incentives will not also be changed. Most important, business investment might be curtailed out of the fear that accelerated depreciation formulas and other investment incentives would also be scaled back.

If citizens lack confidence that their government has the mettle to stick to a course wisely charted, they will anticipate a resurgence of inflation. Under those circumstances, I am afraid that they will not save and invest at the levels the economy so desperately requires to acquire new leadership in world markets and to provide expanded and secure employment opportunities.

The Economic Report of the President's Council of Economic Advisors is surely correct in stating that, "The speed with which the economy adjusts to the Administration's policies will largely be determined by the extent to which individuals at home and at work believe the Administration will maintain unchanged its basic approach to personal and business taxation, Federal spending and regulation, and monetary policy."

So I am concerned that many in government—and apparently many on Wall Street—after considering the Administration's plan so worthy of enactment last year, now judge that plan a failure scarcely after it has been implemented. In fact, the additional personal funds for saving and investment made possible by the tax cuts are just now beginning to become available. Furthermore, favorable tax policy is not the only factor that businessmen have to consider before making investments. The fact that we are in a recession and interest rates are high is making it very difficult for businessmen rapidly to take advantage of the new tax incentives.

I am worried that premature abandonment of the fiscal policies announced by the Administration might signal a return to the conditions of the past decade: rapid policy changes; wide swings in economic activity; rising inflation; declining productivity.

TAX CUTS AND THE PRIVATE CREDIT MARKET

Having said that I support the directions of recent fiscal policy, I will admit that I am very concerned by the size of the projected deficits—particularly the long-term projections—and the effects those deficits will have on the private credit market. In this context, it must be stressed that the deficit we face is in large part the result of tax reductions—not increases in government spending. With the higher private savings—both corporate and personal—that will result from the tax cuts, the demands of public sector borrowing can be met with less effect on interest rates and the availability of funds for private borrowing.

An increase in deficits caused by a tax cut will not reduce the supply of credit to private borrowers dollar-for-dollar. Part of the tax cut will be saved by individuals and corporations, thus strengthening the private credit markets. The larger the share of the tax cut that is saved, the less effect any resulting deficit will have on these markets. We can expect a large share of the corporate tax cut to be saved by businesses. Moreover, the Economic Recovery Tax Act of 1981 provided a package of personal tax cuts specifically aimed at promoting personal savings. In addition, the bulk of the tax cuts will go to those whom we would expect to save the added income. Accordingly, the argument that tax reductions necessarily hurt the private credit markets dollar for dollar in unfounded. If we are concerned about the adverse effects of deficits on the private credit market, we should cut expenditures and not increase taxes. Raising taxes on those who save and invest will reduce the deficit, but it will retard job-creating investments, and it will not reduce interest rates.

CHANGES IN THE LONG-TERM CAPITAL MARKET

A strong and health economy requires long-term, job-creating investments. But we have seen a diminution in the funds available for these very investments.

Through the mid-1950's the life insurance industry was the principal source of long-term investment funds. Those funds are no longer available in our industry in the amounts they once were. Indeed, at a meeting of 100 life insurance investment

officers within the last month, only one said his company had a significant amount of funds available for long-term bonds. Among the factors reducing available funds is a dramatic increase in policy loans.

Furthermore, with those funds that are available for investment, there has been a shift from investments that will create jobs and increase productivity to those that will protect against inflation. Since the mid-fifties, pensions have become an important additional source of funds for long-term investments. But today, those funds are being increasingly directed to investments such as real estate, agriculture, and timberland.

The saving pattern of households have also contributed to the weakness of the long-term investment market. In 1980, households increased their funds in time and savings deposits at banks and thrift institutions by $130 billion, while they put only $30 billion into Money Market funds. In 1981, however, savings and time deposits rose only $58 billion while Money Market funds rose by $112 billion.

Finally, the government has absorbed an increasing share of the long-term bond market—at the expense of the private sector. Between 1956 and 1960, federal debt financing constituted only 2.6 percent of the total credit raised in the capital markets. In 1980, it reached 18.9 percent of that market. The nature of the government borrowing has also changed as the government has attempted to "stretch out" the federal debt. In 1975, the average maturity of privately held government debt was 29 months. Today it is 49 months—more than four years. Accordingly, government borrowing is not only expanding, it is crowding out more and more of the critical long-term market. In 1975, the level of government long-term borrowing was less than a third of that of corporate long-term borrowing. By 1981, this ratio had changed radically, when government long-term borrowing was almost 50 percent greater than corporate long-term borrowing.

In light of these changes in the capital market, this may be the appropriate time to review carefully the impact of government policies on the long-term private market, particularly the policy to stretch out the federal debt.

RECOMMENDATIONS

The comments I have made lead to the following four additional recommendations.

First, with respect to tax policies, the savings and investment incentives enacted last year must be retained. We cannot afford to turn back on the personal and corporate tax cuts designed to spur investment. However, there may be tax loopholes that should be closed and additional sources of tax revenues that can be utilized. Those tax increases must not, however, have the effect of diminishing savings and investment, or be perceived as a reversal of policy.

Second, the rate of increase in defense spending should be subject to close and careful scrutiny. No portion of the federal budget should be declared off limits—particularly a portion as large as defense. Few Americans question the need for increased military spending, but some question whether such a rapid increase can be cost-effective.

Third, because of recent and prospective tremendous increases in Social Security benefit payments, and the trust fund's current deficit, I believe the Social Security program is in need of urgent reform. A strong and dependable Social Security program is essential to help assure the basic income needs of elderly Americans following retirement. But because of the widely recognized cash-flow problems expected in the Social Security Funds over the next few years, the nation now faces both the necessity to correct the short-term imbalance between revenues and obligations, and the opportunity to place the system on a financially sound basis that will function reliably not only for this generation but for future generations as well.

The National Commission on Social Security Reform is scheduled to submit its report by the end of this year. I hope that the Congress will act promptly on the Commission's recommendations.

I want to stress that I do not advocate balancing the budget by cutting Social Security benefits. But the system must be put on a sound economic basis and be perceived as such by the public. Too many people now do not expect to receive benefits from the system, and that is wrong.

Fourth, the search must continue for further cuts in social programs. But cuts must not be indiscriminate or at the expense of our most powerless citizens. I don't envy the Congress its difficult task to insure that the additional cuts will not come at the expense of the most vulnerable. However, we must not lose sight of the fact that the best way to insure the goals we all share for our social programs is to have a healthy and growing economy.

In conclusion, let me reiterate the importance of consistency and stability in the fiscal policy of the federal government. The purpose of the incentives structured into fiscal policy is to influence private spending and investment behavior. But those incentives can only work if they remain intact. There is no point in enacting incentives if the people you want to influence believe those incentives might be repealed soon thereafter.

Deficits—as well as inconsistent policies—damage public confidence. The projected deficits must receive serious consideration and firm remedial measures. If they continue to rise, the public will know that a massive problem is being postponed and will be uncertain of the eventual remedy the government will choose. So it is critical that we continue to reduce the size of the federal government's share of our national economy, and that we bring those deficits down. These efforts will demonstrate convincingly that the government is willing and able to provide a sound political environment in which the economy can grow.

But reversal or repeal of the Economic Recovery Tax Act less than a year after it was enacted would demonstrate just the opposite. Paralyzingly high tax rates—rates that would choke off private investment for new jobs and increased productivity—would be a terrible price to pay. Raising taxes anew—with policy swings and uncertainties—is no way to ease the nation's pain.

In closing, let me emphasize that if I thought we had adopted policies that were not sound for the long-term, I would not hesitate to support changes in the Administration's policy. I would not even hesitate to support its fundamental redirection. But I do not believe the basic principles of the Administration's policy are in error. While no one can guarantee that the Administration's policy will work, it is plain that the policies we pursued in the past, of ever-increasing federal expenditures and taxes, are no longer appropriate.

We simply have no choice but to shift a larger share of our resources to private investment if we are to make the future economy stronger and more productive. This can be done by shrinking the share of GNP going to government spending and by encouraging saving and investment. This is the direction the Reagan Administration has chosen; I hope we have the courage and conviction not to veer from it.

Mr. PICKLE. The Chair would suggest that we receive the testimony of all the witnesses and then we would be open for questions by the committee.

The Chair recognizes Mr. Carl Beck, president of the Charles Beck Machine Corp.

Mr. Beck.

STATEMENT OF CARL A. BECK, PRESIDENT, CHARLES BECK MACHINE CORP., KING OF PRUSSIA, PA., ON BEHALF OF THE NATIONAL SMALL BUSINESS ASSOCIATION

Mr. BECK. Thank you, Mr. Chairman.

I am Carl A. Beck, a small manufacturer of industrial machinery in King of Prussia, Pa. I had an opportunity to appear last year before several House committees and appreciate the opportunity of being invited back again this year.

I would like to submit our written testimony for the record and just offer a few comments.

Mr. PICKLE. All the witnesses' statements will be included in their entirety.

Mr. BECK. We have a concern, of course, that we haven't seen all the details yet of the administration's program, and some of the details will be critical perhaps as to their effect. These details of course not being available yet, we can perhaps only generalize. Nevertheless, I think there are some points that need to be made.

First, I think the small business community in my experience and my exposure is unanimous in the belief that the problem of inflation must be met head on, not only from the viewpoint of the economists' figures, but from the viewpoint of expectations.

If there is anything that hurts the small business community, perhaps it is inconsistency or the inability to look and plan ahead with some reliance on what is going to happen in the future.

Jumping from one kind of tax cut to rescinding tax cuts and so on certainly doesn't tend to indicate a continuity that they can live with. The interest rate problem, as you know, is very real for many small businessmen. Certainly inflationary expectations have a real part of that. I know it is of interest to the Government, too.

My rough calculations say that if we can get inflation down another 1 percent, that over the long run of several years that means a $20 billion reduction in the Federal deficit. That is more money that I borrow from time to time, but nevertheless interest rates to the small businessman are important to him, just as they are to the Government. So that inflation should be the number one enemy. We are glad to see that it is going down, and we hope that after the administration's program has been in effect for longer than this short period of time, we will find further reduction.

When we talk about accelerating payments, many of us look at this as a one-shot acceleration that might help for this year or in the immediate future, but not too much over a longer period.

I advised you that the small businessman is concerned if his taxes and his prepayments are accelerated because he again has a very difficult time with interest rates and in many cases will have to borrow money to prepay some of those taxes, contract taxes and so on that are referred to in the administration package.

So that if there can be some sort of de minimis elimination of applicability to the small businessman where the amounts are under a certain minimum amount, it will certainly be helpful to the small business community.

The other thing is let's be sure that when we start talking about prepayments and changing the method of payment for Government contracts, that we don't create a lot more paperwork because this can be just as costly.

If the recordkeeping and paperwork requirements are too difficult for the small businessman over what we have today, again it is a real cost, so that we hope that either the Congress or the agencies that might be involved in these things would have the liberty to keep the paperwork at a minimum.

The third aspect that I would like to touch on briefly is the comment about user fees. I think most of us agree that paying for services we get is worthwhile, but I hope we don't carry the user fees to an extreme.

We have an aviation trust fund with a considerable amount of money in it. The money was meant for airport development. It hasn't been used. It is now being earmarked to pay the ongoing day-to-day expenses of the FAA. That is not what it was meant for, and yet they are talking about increasing user fees even higher for aviation.

To many a small businessman, particularly out in the west, the use of an airplane is part of his cost of business because the gasoline-powered airplane is basically a tool of small business. I am not talking about corporate jets or the airliners.

Another example is the Coast Guard. We recognize that part of the duties of the Coast Guard is to guard the coast of the United

States. This isn't necessarily a user fee. There is a public benefit here. Just like we don't pay the policemen when they patrol the highways for us, I think there is a limit to how much we can ask the user of the waterways to pay the Coast Guard fees for services rendered. Certainly there is public benefit in this area.

In the area of patents, there are public benefits in the patent system, and to expect the innovator—as we know, most of the innovation development is coming from the small business sector—to expect the small businessman to pay large fees for patent protection tends to move against the encouragement of innovation by the small business sector and, therefore, is bad for the economy in general.

Sir, I will be glad to answer any questions that might come up later on.

Mr. PICKLE. We appreciate your statement, and we appreciate the fact that you have summarized the points you have made. I have looked at your testimony, and it is a good statement. It will be made a part of the record.

[The prepared statement follows:]

STATEMENT OF CARL A. BECK ON BEHALF OF THE NATIONAL SMALL BUSINESS ASSOCIATION

Good Morning. My name is Carl Beck, and I am President of a small manufacturing company in King of Prussia, Pennsylvania. This testimony is in behalf of the National Small Business Association (NSB), a multi-industry trade association founded in 1937 which has grown to include about 50,000 small businesses nationwide. As past president of the Association, I was privileged to appear before House Committees several times during 1981 on the Administration's tax proposals, and we appreciate being invited back to comment on the 1982 round of these proposals.

Contained in the Administration's budget for fiscal year 1983 (beginning October 1, 1982) there are 25 revenue raising proposals classified under four headings: "Selected Tax Revisions," "Improved Tax Collection and Enforcement," "Other Management Initiatives," and "User Fees."

The revenue increases proposed by the Administration are summarized in the following table according to these categories:

PROPOSED REVENUE INCREASES BEGINNING IN FISCAL YEAR 1983

[In billions of dollars]

	Fiscal year—	
	1983	1983-1987
Selected tax revisions	7.2	65.8
Improved tax collection and enforcement	5.5	21.0
Other management initiatives	12.4	64.5
User fees	2.5	18.3
Total	27.6	169.6

These proposals are designed to raise $27.6 billion in new 1983 revenue and an average of about $34 billion per year for 1983-87 period. The grand total of $169.6 for the five years would constitute one-half of the amounts ear-marked by the Administration to reduce the deficits during this period. A listing of each of the 25 proposals, compiled by the National Journal Magazine is attached to our testimony as an Exhibit.

We can offer the committee our tentative impressions of the small business impact of the tax revisions on the basis of the brief descriptions set forth in the Administration's budget of February 8, 1982. This, however, is with the caution that the details of these measures will be critical to their effect, and those details have not been available during the preparation of this testimony.

During the formative period, we noted several rays of hope for small business. In the Daily Tax Report (Bureau of National Affairs, February 11, 1982, page G-3), Treasury Secretary Regan was reported as expressing a willingness to consider "small business exemptions" on the completed contract and withholding provisions. However, the summary language in the budget proposals does not yet reflect such exclusions. ("Receipts Proposals," Budget of the United States Government, fiscal year 1983, Section 4-11.)

The budget documents did, however, offer hope that the industrial revenue bond matter would be resolved favorably for small business, by stating that "small issue industrial development bonds will not be allowed for large businesses."

A follow-through toward such reasonable and consistent small business considerations for the 1983 provisions would be a happy ending to this chapter of the story. That could make it very much in order to commend the Administration for such small business considerations recognizing the special character of smaller enterprises, and thus averting problems which might otherwise have arisen for small business and the economy.

SMALL BUSINESS ASPECTS OF THE TAX REVISIONS

A brief review of the major tax revisions follows:

Completed contract method of accounting.—The "completed contract" procedures the Administration proposes to eliminate would adversely impact some small businesses as well as large business. Although there are alternative accounting measures available, any change would be more burdensome for smaller firms. Accordingly, the concept of a small business exemption proposed by the Secretary of the Treasury makes good sense to us, and we would suggest tht it be at the $100,000 level, to be consistent with the demarcation level in the corporate income tax.

Business energy tax credits.—From the Administration's rationale for this change, it appears to be a perfect place for an equivalent small business exemption.

This Administration's argument is that "with decontrol of oil and natural gas prices, businesses no longer need additional investment incentives for energy conservation and the development of alternative energy sources."

However, this overlooks the serious capital formation problems created for small firms by the past and future surges in energy prices. Small enterprises are much less able to bear the extra costs of operation of higher fuel prices. When such firms attempt to go further and raise enough capital for investments to reduce energy use, they are shouldering a double financial burden.

Millions of our business structures presently in use were erected during the era of energy abundance. They must be retro-fitted by their small business owners in order to be energy efficient. Energy tax credits are not only "incentives," they are vital for capital formation, because the bankers considering the financing of these improvements can count on quicker recovery of the investment and therefore quicker repayment.

The three year total of revenues involved in the full elimination of the energy provision is $1.1 billion. So, the costs of preserving it on a transitional basis would be minor and the benefits would be very great in terms of energy conserved, jobs maintained, business and community stability and national economic strength.

Tax exempt revenue bonds for private activities.—When the question of restricting industrial revenue bonds first arose last September, the National Small Business Association voiced its support of a number of improvements, including a requirement of local hearings, reporting of all IDB projects to the Treasury Department, and a comprehensive evaluation with recommendations for curbing any uses found to be inappropriate.

The Congressional Budget Office study of April 1981, found that 93 percent of the number and 84 percent of the volume of such bonds finance businesses other than the "fortune 1000." A New York State survey found that three quarters of the issues benefited firms with yearly sales of less than $20 million, and one-half went to very small enterprises with sales of $1 to $5 million annually.

We would therefore support reasonable limitations on this form of financing that would leave the medium open for legitimate qualified small business firms.

Modified Co-Insurance.—We do not believe this issue concerns the small business community.

Construction Period Interest and Taxes.—On the surface it would appear that the proposal would equate the tax treatment of interest for corporations with that presently applying to individual taxpayers. However, the proposal comes in the context

of a building industry which has been depressed for the last three years.[1] As a consequence, some economists are predicting a restructuring of the entire construction business toward a "smaller scale industry." ("Home builders expect a persistent slump, with a slow recovery, shrinking industry" Wall Street Journal, February 8, 1982, page 29:4)

With this background, we believe that Congess should hesitate to impose additional taxes at this time, particularly to the extent smaller firms are involved.

Alternative Corporate Minimum Tax.—Our organization could not assess the effect of a new alterative minimum tax on the existing small businesses, and particularly start-up businesses. While we would withhold final judgement on this proposal, pending review of the specific provisions, our interim reaction is to advocate a $100,000, or similar exemption, to avoid what might be vexing small business problems in this area.

Withholding on interest and dividends.—We agree with Secretary Regan that a de minimis provision should apply in this area either in terms of the number of recipients of the amount involved or both. This could avoid burdensome paperwork which is not cost-effective in collecting revenues. Perhaps the 25-person standard of the small business (Subchapter S) corporation would be an appropriate standard.

Acceleration of corporate tax payments.—Again, we would like to evaluate the details of this proposal in the context of the high interest rates which, since October 1979, have made it so difficult for small businesses to finance inventories and receivables.

Patent fees.—There is likewise a differential between small and large businesses of patents. Costs for patent applicants are already increasing materially under Public Law 96-517, which small business supported. However, this 1983 proposal would require patent applicants to pay for 100 percent of patent office costs on the theory that they alone are the "users" of the office. This is an incomplete view, since society as a whole derives the major benefits from innovation. Large corporations are far more able to bear such costs. Therefore, a higher fee schedule across the board will place small businesses and individual inventors at an even greater disadvantage than under the present law.

Throughout this century, half of all innovations came from these sources, so it would be very much in the interest of the economy as well as small enterprise to modify this proposal.

LEVEL OF THE REVENUE REDUCTIONS

The Administration's budget projections for the 1981-87 fiscal years are as follows:

ADMINISTRATION'S BUDGET PROJECTIONS AT A GLANCE

[In billions of dollars]

	Fiscal year—						
	1981	1982	1983	1984	1985	1986	1987
Receipts	599.3	626.8	666.1	723.0	796.6	861.0	925.7
Outlays	657.2	725.3	757.6	805.9	868.5	927.0	978.9
Deficit	−57.9	−98.6	−91.5	−82.9	−71.9	−66.0	−53.2

However, commentators across a spectrum of viewpoints have noted that these totals are conservative. Among other things, they are contingent upon Congressional approval of almost $56 billion of fiscal year 1983 specific revenue and spending actions.

Without changes of this magnitude, forecasters such as Data Resources, Inc. predict fiscal year 1982-1984 deficits of $120.3 billion, $152.0 billion and $188.9 billion. ("Economic Policy and the Economic Outlook," testimony by Allen Sinai, Senior Vice President, Data Resources, Inc., before the Joint Economic Committee, January 20, 1982, pages 4 and 21.)

In our view, it is just such expectations that have been keeping interest rates in the 20 percent range for small business for almost two and one-half years.

[1] During 1981 building industry bankruptcies rose 56 percent from 1980, with housing production hitting a post-war low of 1,086,000 units.

According to the testimony of a highly respected former chairman of the Council of Economic Advisers, Alan Greenspan:

"It is not supply in the short run of government securities that is keeping interest rates high. It is the expectation that devicits are $120, $150 or $200 billion in the latter part of the 1980s that is causing the problem today." (Testimony before the Senate Small Business Committee on "Interest rates and Business Credit Needs," September 23, 1981, page 139.)

As the Committee is aware, those conditions resulted in over 17,000 business failure last year (according to Dun & Bradstreet). This represented a 45.1 percent increase over calendar year 1980, and a 96 percent increase over the average of the previous five years. It is within a whisker of the 1961 total the highest since the Depression.

Accordingly, we believe that the state of small business at this time is precarious.

We heartily endorse Administration goals of creating more savings and investment. We also believe that the prospective deficits for 1983 and beyond are too high, and that the Legislative and Executive branches should cooperate in putting the budget on a path which is closer to fiscal balance, thus enabling the Federal Reserve to make compensatory adjustments in monetary policy.

As Data Resources, Inc. pointed out:

". . . the paradox is that a rising deficit itself can bring about an even worse deficit through raising interest rates, slowing real growth, increasing unemployment and restraining inflation. Measures to reduce the deficit, such as raising taxes, or lowering spending, could reverse this set of results." (January 20, 1982, testimony, page 22).

We believe, in these ways, the same objectives can be reached in a manner which is more balanced for the economy and less threatening to small business. Our 15 million small firms account for about 80 percent of existing jobs, 70–80 percent of new employment, and over half of the industrial innovations that are the country's best hope for increased productivity and international competitiveness. They represent a wellspring of opportunity for all our citizens.

It has become widely recognized that a 1 percent reduction in the unemployment rate cuts the budget deficit by $20 to $30 billion. It is because of this that we have consistently advocated the general jobs tax credit as a cost-effective way to make greater use of small businessses in the solution of many of the central problems of the economy.

A policy which encourages small business will result in the kind of economic tax growth, productivity, job creation, exports and our overall performance that the Administration and Congress seek.

If tax policy swings further against small firms at this critical juncture, we are gravely concerned about the perils for both the small business community and the national economy.

Revenue: The Source of Half the Deficit Cuts

(By Timothy B. Clark)

The Reagan Administration hopes to increase the government's revenues by $27.6 billion next year and by $170 billion during the next five years. That represents almost half of the deficit-cutting measures it is proposing for fiscal 1983 and more than a third of those sought for 1983 through 1987.

You won't find those numbers in the budget sent to Congress on Feb. 8, however, unless you read it very carefully. They represent the total of all measures that would increase the dollars collected by the Treasury, whether directly through taxes or user fees, indirectly by improving tax collection procedures or through the back door by selling government assets.

The budget lists $55.8 billion in deficit reductions for 1983 and $447 billion through 1987. The 25 revenue raisers would account for 49 percent of the total in 1983 and 36 percent for all five years.

The Administration doesn't characterize these measures as tax increases. Instead, the budget groups its 25 revenue proposals under a variety of headings, only one of which—"selected tax revisions"—is meant to suggest actual tax collection and enforcement," other "management initiatives," and "user fees." Following is a list of proposed steps.

SELECTED TAX REVISIONS

These would raise $7.2 billion in fiscal 1983 and $65.8 billion in 1983–87, as follows:

Completed contract accounting—This accounting method, by which companies defer taxes on income from long-term contracts, would be disallowed. 1983 revenue gain: $3.3 billion. 1983–87: $17 billion.

Business energy tax credits—These credits for investment by business in energy-saving equipment and structures would be repealed as of next Jan. 1, 1983 gain: $100 million. 1983–87 gain: $2.3 billion.

Tax-exempt bonds—Their use for industrial development and other purposes would be curtailed. 1983 loss: $200 million. 1983–87 gain: $6.6 billion.

Modified co-insurance—Insurance companies are now able to make co-insurance deals that reduce their tax liability. The Administration proposes to eliminate these "unintended tax benefits." 1983 gain: $1.1 billion. 1983–87 gain: $11.5 billion.

Captialization of interest and taxes incurred during construction period—Firms would no longer be able to write off these costs immediately. 1983: $500 million. 1983–87: $4.6 billion.

Corporate minimum income tax—This tax would be revised and would apply only to those corporations that pay very low regular tax rates. 1983: $2.3 billion. 1983–87: $23.8 billion.

IMPROVED TAX COLLECTION AND ENFORCEMENT

This category, a subsection of "management initiatives," would bring in $5.5 billion in 1983 and $21 billion in 1983–87.

Withholding on interest and dividends—Five percent of taxable interest and dividends would be withheld. 1983: $2 billion. 1983–87: $8.2 billion.

Corporate tax collection speedup—Firms would be required to pay 90 percent of estimated liability instead of 80 percent and to remit the remaining liability sooner. 1983: $1.4 billion. 1983–87: $4 billion.

IRS enforcement—The Interest Revenue Service would increase its enforcement staff by more than 5,000. 1983: $2.1 billion. 1983–87: $8.8 billion.

OTHER MANAGEMENT INITIATIVES

Although these steps increase flows of money into government coffers, they are counted as "negative outlays" and thus reduce federal spending. The five steps listed here would raise $12.4 billion in 1983 and $64.5 billion in 1983–87.

Improved debt collection—Delinquent debtors would be pursued with more vigor and new delinquencies would be avoided. 1983: $1 billion. 1983–87: $8 billion.

Federal property disposition—"Underused" federal property would be sold and other property would be managed more efficiently. 1983: $1 billion. 1983–87: $17 billion.

OCS leasing—Leases of Outer Continental Shelf tracts with greater potential for oil and gas production would be accelerated. 1983: $8.4 billion. 1983–87: $33.7 billion.

Assets sales management—Sales of government assets would be managed more effectively. 1983: $1.3 billion. 1983–87: $4 billion.

Mortgage insurance—The method for charging home buyers for federal insurance premiums would be changed. 1983: $684 million. 1983–87: $1.8 billion.

USER FEES

The budget makes no fewer than 12 proposals to institute new user fees or increase old ones. A revenue gain of $2.5 billion is predicted for 1983, and gains would total $18.3 billion in 1983–87. The individual proposals come from the budget document entitled "Major Themes and Additional Budget Details." The revenue generated by the components falls somewhat short of the total new revenue claimed elsewhere in the budget.

Aviation—The tax levied on airline passengers would be increased to 8 percent and taxes on general aviation gasoline and jet fuel would be raised. 1983: $1.2 billion. 1983–87: $7.7 billion.

Coast Guard services—Commercial and recreational boat users would be required to pay the Coast Guard for its services. 1983: $200 million. 1983–87: $3.4 billion.

Commodity trading fees—Traders would pay enough to cover all costs of the Commodity Futures Trading Commission. 1983: $22 million. 1983–87: $111 million.

Energy regulation—New and increased fees would be charged to those using services of the Federal Energy Regulatory Commission. 1983: $35 million. 1983–87: $172 million.

Inland waterways—Traffic would be charged for costs of federally financed improvements to the inland waterways. 1983: $448 million. 1983-87: $2.4 billion.

Nautical and aeronautical maps and charts—Increased fees would allow the government to recover all its costs by 1985. 1983: $14 million. 1983-87: $175 million.

Patents and trademarks—Fees would be increased to cover full costs of processing applications. 1983: $39 million. 1983-87: $234 million.

Nuclear waste disposal—Fees would be charged nuclear utilities to cover costs of waste disposal. 1983: $300 million. 1983-87: $2.6 billion.

Recreation—Entrance fees at federal recreation areas would be increased. 1983: $63 million. 1983-87: $344 million.

Veterans' housing loan guarantees—Recipients of loan guarantees would have to pay a fee equal to 0.5 percent of the loan. 1983: $95 million. 1983-87: $535 million.

Ginnie Mae mortgages—Fees charged issuers of Government National Mortgage Association securities would be increased. 1983: $4 million. 1983-87: $20 million.

Grievance arbitration—Fees would be instituted to cover the costs of government provided services. 1983: $5 million. 1983-87: $25 million.

Mr. PICKLE. The Chair recognizes Mr. James H. Evans, chairman of the board of the Union Pacific Corp.

Mr. Evans.

STATEMENT OF JAMES H. EVANS, CHAIRMAN OF THE BOARD, UNION PACIFIC CORP., AND COCHAIRMAN, THE BUSINESS ROUNDTABLE

Mr. EVANS. Thank you, Mr. Pickle, other members of the committee.

I am happy to be here as chairman of Union Pacific, which is a 10,000 mile railroad in the West. It also is an oil and gas company called Champlin Petroleum, located in Texas, and a mining company in Denver and a land company headquartered in Los Angeles.

I am also here as cochairman of the Business Roundtable, which is an organization of some 200 companies. The Roundtable examines public issues that affect the economy and, in turn, develops positions which seek to reflect sound economic and social principles.

During the past year, Mr. Pickle and gentlemen of the committee, the Roundtable has strongly supported President Reagan's program to stimulate economic recovery. Bipartisan efforts to reduce taxes, to relax regulations and to control inflation and reduce the growth of Federal spending have started the country, we believe, in the right direction toward sustained economic growth with essential price stability.

The Roundtable also believes that it is a sound, long-term program. The business community and the Congress should stay with it and, most importantly, give it time to work. However, achievement of this goal will not be easy.

It will take no less than a strong bipartisan effort on the part of all of you working with the administration to come to the right conclusions.

Because the Roundtable has not met since the budget document was submitted on February 8, we have not considered several of these programs. Therefore, I cannot represent them, Mr. Pickle, totally with respect to their thinking.

We do know in the Roundtable companies that there are anxieties about the size of the projected deficits for 1983, 1984, and 1985. We share these anxieties very much, and we are concerned about the impact of these soaring deficit estimates, particularly on financial markets.

A consensus appears to be emerging within the Roundtable companies that continuation of large deficits and the inevitable pressures on the Federal Reserve to monetize these deficits will produce high interest rates that retard vigorous recovery from the recession. The recession increases the deficits, and thus we have a vicious circle.

The only way that this vicious circle can be broken is to develop a plausible plan for achieving lower deficits in future years. This plan, coupled with a steadier monetary policy, will reassure the financial markets and should result, we believe, in lower interest rates.

We know the administration has proposed deficits of $92, $83, and $72 billion respectively for the future. If budget savings do not materialize, the deficits will be twice as large. Legislative action must be taken not only to hold the deficits to the levels projected, but also to close the deficit gap further and to generate a decisive downward trend.

It is essential for future financial stability and growth that the Government establish proper controls over its own budget. We have several options: Cut nondefense spending, moderate the growth of outlays for defense spending and entitlement programs, raise revenues, or a combination of these. The choices are excruciatingly difficult.

To the extent that the budget deficits can be closed through reductions in the expenditure side, it is preferable for the long-term health of the economy. In this regard, no area of budget expenditures should be free from very close scrutiny, including defense and entitlements. We are not advocating reduction in outlays for these programs, just slower rates of growth in the future.

In particular, we cannot postpone much longer the difficult problem of bringing entitlement programs under control and placing them on a sound financial basis.

Entitlements represent 47 percent of budgeted expenditures for 1983. They have been increasing at an overall rate in excess of the general rate of growth of the economy. It is a matter of simple arithmetic that this condition cannot endure forever.

As one of my business colleagues and a former Secretary of Commerce, Peter Petersen, recently noted:

> Social Security benefits shot up 55 percent faster than the price level during the 1970s. By contrast, the average weekly income of wage earners, who must pay the benefits, rose less than 2 percent in real terms. . . . In 1970, the typical married worker received, upon retirement, Social Security payments amounting to about 60 percent of his after tax wages. Today, that has jumped to 90 percent.

One of the major factors driving up these expenditures is that they are 100 percent adjusted to the Consumer Price Index by a process called indexing. I think other members of this panel and Mr. Blumenthal addressed that very adequately.

Financial pressures can also be relieved by reducing off-budget loan guarantees and direct lending by Government-sponsored enterprises. These can be almost as important in terms of early impact on the credit markets as budget deficits themselves.

Direct borrowing by the Treasury in 1981 amounted to $79.3 billion, but guaranteed loans and Government-sponsored enterprise

borrowing raised the overall credit demand another $62.8 billion, to a total of $142 billion.

We recognize that spending cuts alone will probably not lower the deficit projections for fiscal years 1983–84 to appropriate levels. Therefore, revenue increases must also be considered.

We support increases in user charges that the administration has proposed, we would not rule out the possibility of increasing excise taxes, and we would favor eliminating any tax subsidies that upon review by your committee are deemed to serve little purpose.

The Federal income tax system has for a number of years acted as a disincentive to business investment and has discouraged personal savings and productive effort. The Economic Recovery Tax Act of 1981 was designed to partially offset this distortion and encourage capital formation.

We believe the 1981 Economic Recovery Tax Act, if given a chance to succeed, should provide the tax relief required for both individuals and businesses to stimulate consumer and business spending and provide the increase in economic activity and productivity that will create more jobs and increase the tax base.

Concern has been expressed that the new tax law has failed because there has not been an immediate upsurge in business investment spending. However, changes in the tax law alone do not determine investment decisions. These decisions are a function of profit opportunities, market forces and interest rates, as well as taxes.

A capital spending boom should not be expected in the face of high interest rates and a sagging economy. Tax law changes can help spur investment, but cannot be expected to do the entire task.

To illustrate, in my business, speaking of the Union Pacific Railroad, the reduction in the depreciable lives from 11 years to 5 years for railroad cars used for hauling grain will significantly increase the rate of return on such investments by increasing cash flow.

It doesn't make sense for our company to increase our purchases of grain cars as long as grain shipments are down sharply and an industrywide surplus of cars exists.

Right now we have more than 5,000 unused freight cars in the Union Pacific of our total fleet of 66,000 cars. We have more than 1,650 locomotives which cost about $1 million apiece, using current prices. Of our total locomotives, nearly 400 are stored in the desert, being unused at this time. Therefore, we are not making plans to buy any new locomotives.

With respect to monetary policy, we believe that monetary policy should be re-examined. During the past 2 years both long-term and short-term interest rates have averaged at extraordinarily high levels.

Mr. Blumenthal talked about the risk rate that is being required. We know that economists who appeared before you yesterday and others have no satisfactory answer for this sudden separation of the link between interest rates, inflation and real economic growth, except fear and the concern for protecting the future, just as Mr. Beach talked about earlier.

Inasmuch as the bulk of the increase in interest rates of the past 2 years occurred between 1979 and 1980 before the present admin-

istration's fiscal policies were known, it is hard to attribute recent interest rate behavior to the deficits now being projected.

On a short-run basis, it appears that each time the Federal Reserve allows the money supply growth rate to accelerate, interest rates, both short and long term, increase virtually coincident with what appears to be monetary easing.

Whenever the Federal Reserve has moderated the rate of growth in the money supply or reduced it, interest rates have stabilized or declined. Consequently, it is difficult to assign high and rising interest rates to a restrictive monetary policy.

It appears, however, that the markets are most disturbed and drop the price of fixed income securities whenever it appears that the Federal Reserve is heading toward a more expansionary and, hence, a more inflationary policy.

I have no doubt that the prospect of large deficits is also having an adverse psychological effect on bond markets. These high interest rates are very troubling to many people seeking to finance the acquisition of capital goods. This is equally true for households seeking to finance the purchase of automobiles and new homes.

The continuation of these high interest rates are an impediment to the normal capital management of corporations whereby some proportion of short-term indebtedness is funded in long-term liabilities.

It also appears that these high interest rates represent in the financial markets a lack of confidence in the ability or the willingness of monetary and fiscal policies to pursue a consistent and steady strategy to reduce inflation and enhance economic growth.

I don't think that it serves any useful purpose to blame fiscal policy for high interest rates, nor for administration spokesmen to blame monetary policy. The fact is that the financial markets are extremely volatile, continuously disturbed, and they create uncertainty for those of us managing businesses.

I would urge the administration and the Federal Reserve to both take steps to improve the conduct of monetary and fiscal policy to reduce the present ambiguity.

In summary, American business wants to see a strong, prosperous and growing economy. Business wants an economy that provides every citizen a job opportunity. We believe such an economy is possible during this decade.

While in the short term we are concerned about the escalating budget deficits and their potential impact on interest rates, we continue to believe that the President's economic program provides a sound foundation to accomplish long-term objectives that are in this country's best interest.

For these reasons, we continue to support it strongly. We should "stay the course". We should be steady and consistent with both fiscal and monetary policy.

Mr. PICKLE. Thank you, Mr. Evans.

[The prepared statement follows:]

STATEMENT OF JAMES H. EVANS, COCHAIRMAN, BUSINESS ROUNDTABLE

Mr. Chairman, and other distinguished members of this Committee, my name is James Evans. I am Chairman and Chief Executive Officer of Union Pacific Corporation. I am also a Co-Chairman of the Business Roundtable and today I am pleased to

be with you as the Roundtable's representative to comment on the Administration's Economic Program. The Business Roundtable is an association of approximately 200 companies. We examine public issues that affect the economy, and, in turn, develop positions which seek to reflect sound economic and social principles.

During the past year, the Roundtable has strongly supported President Reagan's program to stimulate economic recovery. Bipartisan efforts to reduce taxes, relax regulations, control inflation and reduce the growth of Federal spending have started us in the right direction toward sustained economic growth with essential price stability. We believe it is a sound long-term program and that the business community and Congress should stay with it and, most importantly, give it time to work.

However, achievement of this goal will not be easy. It will take no less than a strong bipartisan effort in Congress, working with the Administration, to overcome the obstacles in our path.

The Administration recently submitted to Congress a recommended budget for 1983, 1984 and 1985. This submission occurred after the last meeting of the Business Roundtable. Therefore, my statement today must be somewhat tentative and preliminary in character, as the Roundtable has yet to meet and consider several of the issues raised by the President's recent proposals.

BUDGET DEFICITS

We recognize that there are anxieties about the size of the projected Federal deficits for 1983, 1984 and 1985. We share those anxieties, and we are particularly concerned about the impact that soaring deficit estimates have on our financial markets.

A consensus appears to be emerging within the Roundtable that expectations of a continuation of large deficits and, the inevitable pressure on the Federal Reserve to monetize these deficits, will produce high interest rates. High interest rates retard vigorous recovery from the recession. The recession increases deficits. We may thus have a vicious circle. The only way that this vicious circle can be broken is to develop a plausible plan for achieving lower deficits in future years. This plan, coupled with a steadier monetary policy, will reassure the financial markets and should result in lower interest rates.

The Administration has proposed budgets for fiscal year 1983, 1984 and 1985 that would produce deficits of $92, $83 and $72 billion respectively. If budget savings through spending cuts and revenue enhancement of some $239 billion do not materialize, the deficits will be twice as large. Legislative action must be taken, not only to hold the deficits to the levels projected, but also to close the deficit gap even further and generate a decisive downward trend. It is essential for future financial stability and growth that our Federal government establish appropriate control over its own budget.

We have several options—cut non-defense spending, moderate the growth of outlays for defense spending and entitlement programs, raise revenues, or a combination of these. The choices are excruciatingly difficult.

To the extent that the budget deficits can be closed through reductions in the expenditure side, it is preferable for the long-term health of the economy. In this regard, no area of budget expenditures should be free from scrutiny, including defense and entitlements. We are not advocating reduction in outlays for these programs, just slower rates of growth.

In particular, we cannot postpone much longer the difficult problem of bringing entitlement programs under control and placing them on a sound financial basis.

Entitlements represent 47 percent of budgeted expenditures for 1983. They have been increasing at an overall rate in excess of the general rate of growth of the economy. It is a matter of simple arithmetic that this condition cannot endure forever.

As one of my business colleagues and a former Secretary of Commerce, Pete Petersen, recently noted: "Social Security benefits shot up 55 percent faster than the price level during the 1970's. By contrast, the average weekly income of wage earners, who must pay the benefits, rose less than 2 percent in real terms—that is, after allowing for inflation. In 1970, the typical married worker received, upon retirement, Social Security payments amounting to about 60 percent of his after-tax wages. Today, that has jumped to 90 percent."

One of the major factors driving up these expenditures is that they are 100 percent adjusted to the Consumer Price Index (CPI) by a process called "indexing". We believe that the CPI, as currently constituted, often overstates the rate of inflation as it affects the consumer. For this reason, we support a thorough reexamination of indexing—including the index to be used as well as the frequency of adjustment—as

a major part of an overall program to put our retirement systems on a sound financial basis.

Financial pressures can also be relieved by reducing off-budget loan guarantees and direct lending by government-sponsored enterprises. These can be almost as important in terms of early impact on the credit markets as budget deficits. Direct borrowing by the Treasury in 1981 amounted to $79.3 billion, but guaranteed loans and government-sponsored enterprise borrowing raised the overall credit demand under Federal auspices by another $62.8 billion.

TAXES

We recognize that spending cuts alone will probably not lower the deficit projections for fiscal years 1983-84 to appropriate levels. Therefore, revenue increases must also be considered. We support increases in user charges that the Administration has proposed; we would not rule out the possibility of increasing excise taxes; and we would favor eliminating any tax subsidies that upon review are deemed to serve little purpose.

The Federal income tax system has for a number of years acted as a disincentive to business investment and has discouraged personal savings and productive effort. The Economic Recovery Tax Act of 1981 was designed to partially offset this distortion and encourage capital formation. The 1981 Economic Revovery Tax Act, if given a chance to succeed, should provide the tax relief required for both individuals and businesses to stimulate consumer and business spending and provide the increase in economic activity and productivity that will create more jobs and increase the tax base.

Concern has been expressed that the new tax law has failed because there has not been an immediate upsurge in business investment spending. However, changes in the tax law alone do not determine investment decisions. These decisions are a function of profit opportunities, market forces and interest rates as well as taxes. A capital spending boom should not be expected in the face of high interest rates and a sagging economy. Tax law changes can help spur investment, but cannot be expected to do the entire task.

To illustrate, in my business the reduction in the depreciable lives from 11 years to 5 years for railroad cars used for hauling grain will significantly increase the rate of return on such investments by increasing cash flow. But, it doesn't make sense to increase our purchases of grain cars as long as grain shipments are sharply down and an industry-wide surplus of cars exists.

MONETARY POLICY

We believe that monetary policy should be reexamined. During the past two years both long-term and short-term interest rates have averaged at extraordinarily high levels. After subtracting the current rate of inflation, short-term rates in real terms averaged about 8 percent last year. Real rates in the period since World War II had previously not exceeded 4 percent. Economists have no satisfactory explanation for this sudden separation of the link between interest rates, inflation and real economic growth.

Inasmuch as the bulk of the increase in interest rates in the past two years occured between 1979 and 1980 before the present Administration's fiscal policies were known, it is hard to attribute recent interest rate behavior to the deficits now being projected. On a short-run basis it appears that each time the Federal Reserve allows the money supply growth rate to accelerate, interest rates, both short and long term, increase virtually coincident with what appears to be monetary easing. Whenever the Federal Reserve has moderated the rate of growth in the money supply or reduced it, interest rates have stabilized or declined. Consequently, it is difficult to assign high and rising interest rates to a restrictive monetary policy. It appears however that the markets are most disturbed and drop the price of fixed-income securities whenever it appears that the Federal Reserve is heading towards a more expansionary and hence a more inflationary policy.

I have no doubt that the prospect of large deficits is also having an adverse psychological effect on bond markets at the present time.

These high interest rates are very troubling to many people seeking to finance the acquisition of capital goods. This is equally true for households seeking to finance the purchase of automobiles and new homes. The continuation of these high interest rates are an impediment to the normal capital management of corporations whereby some proportion of short-term indebtedness is funded in long-term liabilities. It also appears that these high interest rates represent in the financial markets a lack of confidence in the ability or the willingness of monetary and fiscal policies to

pursue a consistent and steady strategy to reduce inflation and enhance economic growth.

I don't think that it serves any useful purpose for the Federal Reserve authorities to blame fiscal policy for high interest rates nor for Administration spokesman to blame monetary policy. The fact is that the financial markets are extremely volatile, continuously disturbed and they create great uncertainty for those of us managing businesses. I would urge the Administration and the Federal Reserve to both take steps to improve the conduct of monetary and fiscal policy to reduce the present ambiguity.

SUMMARY

In summary, American business wants to see a strong, prosperous and growing economy. Business wants an economy that provides every citizen a job opportunity. We believe such an economy is possible during this decade.

While in the short term, we are concerned about the escalating budget deficits and their potential impact on interest rates, we continue to believe that the President's economic program provides a sound foundation to accomplish long term objectives that are in this country's best interest. For these reasons, we continue to support it strongly. We should "stay the course". We should be steady and consistent with both fiscal and monetary policy.

Mr. PICKLE. Now we will hear from Mr. Charls Walker, the chairman of Charls E. Walker Associates, our frequent visitor and testifier, world renowned authority, expert, and achiever. I could say some other things.

Mr. Walker, we are pleased to have you.

STATEMENT OF CHARLS E. WALKER, CHAIRMAN, CHARLS E. WALKER ASSOCIATES, INC.

Mr. WALKER. Thank you very much. I appreciate the opportunity to appear before this distinguished committee to give my views on the past, current, and prospective economic scene. I am chairman of Charls E. Walker Associates, chairman of the American Council for Capital Formation, and a member of President Reagan's Economic Policy Advisory Board, but I am testifying today only for myself.

Because my formal statement will appear in the record, I will summarize the first part of my statement and then read the last part, which has policy recommendations that I want to get across exactly as I have written them.

Mr. PICKLE. That would be fine. We appreciate your summary. When you get to the part where you are going to refer to your testimony, advise us.

Mr. WALKER. Before I give my policy recommendations, I want to say a word about how we got into this situation, the problem that existed when the Reagan administration took office, the steps taken to deal with the problem and whether we need some sort of adjustment in the economic game plan adopted last year.

The problem that existed when the Reagan administration took office was "stagflation" with a vengence—double-digit inflation, high levels of unemployment, sluggish rates of economic growth and very low levels of productivity.

The diagnosis of the problem—which the Reagan administration accepted and I think had pretty wide public support and support of the Congress—was that Uncle Sam had grown too big for his britches, that the Federal Government was too big, levied too heavy a tax burden, was too intrusive in terms of regulation, and

monetary policy had been too expansive over too long a period of time.

The best measure of the size of the Federal Government is the ratio of Federal spending to the gross national product. During the 1950's and 1960's when we had strong economic growth, stable prices, and provided adequate funds for defense, Federal spending relative to GNP averaged between 17 to 19.5 percent.

By the time the 1980's came along, Federal spending was averaging 22 or 3 percent of GNP. Levels this high cause many problems.

In the first place, much of that spending represented resource transfer from the more productive sectors to the less productive sectors of society. I don't say that in a critical way, but it is true that gives rise to inflation.

Second, that level of spending will not, I believe, be supported by a middle-class economy which has to bear the brunt of the tax burden.

As a consequence, taxes, although very high, were not high enough to afford balanced budgets. As a result, we had chronic deficits. Those deficits could have been financed, as in West Germany and Japan where their deficits are higher than ours relative to GNP, in a noninflationary way through a tight money policy.

A tight money policy would have meant higher interest rates during the period. In fact, however, we monetized too large a portion of those deficits. Monetary growth was very high during that period.

Thus, the inflation we have experienced stemmed from three factors. First, Uncle Sam grew too big for his britches. Second, resources were transferred from productive to less productive sectors. And third, the Federal Reserve, through purchases of Government securities, indirectly monetized the deficit.

The other side of the coin was the tax burden. Taxes were running at their highest level relative to GNP since World War II. That in turn greatly reduces incentives to work, save, and invest. In addition, the distribution of the tax burden was at odds with the need for economic growth. Our tax system was a product of the outmoded economic and social theories we held in the 1930's. Ther the idea was that we needed, not to save or invest, but to spenc and to consume, in order the spend ourselves out of the depression.

As a consequence, we levied high marginal tax rates on individuals and made an effort to redistribute wealth. In fact, tax policy in that time, to some extent, was made to "soak the rich."

Finally, the marginal tax rates became so high they strongly dampened incentives to work, save, and invest. In addition, high business taxes reduced the rate of return on business investmen and also reduced the cash flow available to fund that investment.

It was widely recognized as we entered the 1980's that our tax system was strongly biased in favor of consumption and against th saving and productive investment, and that we needed to figh "stagflation."

The Reagan administration launched a four-part economic program to deal with "stagflation." "Reaganomics," as the program i called, was developed to reduce the size of the Federal budget relative to GNP. I think this committee may recall that this concep was stated early on in the campaign by candidate Reagan. In Jun

1980, he called for personal and business tax cuts. In September 1980, he reiterated that, over the next 5 years, as we cut taxes, we also needed to reduce the size of Federal spending from the 23 percent of GNP to the 18- to 19-percent level that prevailed back in the fifties and sixties when we had strong economic growth and stable prices.

Congress accepted this program with the enactment of the budget cuts and massive tax legislation last year. The question now is whether the program will succeed or not. Well, it is far too early to say. Moving from an inflationary environment to a less inflationary environment is very difficult and involves much hardship because expectations of inflation are so deeply impressed.

We have made a lot more progress on inflation than people thought would be made. This is, to me, the most significant factor in the last 12 months, but the hardship has come on with a vengeance.

The hardship is in the form of recession, dropping output, and rising unemployment, while interest rates have remained at stubbornly high levels.

A very important part of the administration's economic game plan was to be a decline in interest rates as the inflation rate came down and confidence in the future grew.

The inflation rate has come down but interest rates have not fallen very far.

The fact is, as other witnesses have noted, the real interest rate—the market rate less the inflation rate or the expected inflation rate—are at very high levels.

I think Mr. Evans gave a very good picture of the fear about the Federal Reserve System.

One view is, and this is backed up by the people I have talked to in markets, not the people who make the markets from day to day so much, not the economists who work for the investment banking firms, but I am in touch with people that manage some $425 billion of investment funds.

Their major concern is that the Federal Reserve was so expansive in the 1970's and a belief that at times they are overly expansive in response to political pressures, that the Fed will cave in to political pressures and try to expand the money supply too rapidly to fight unemployment and fight recession.

To be sure, over the past 2 years each time the Federal Reserve has exerted some control over the money supply and it has started to grow at a moderate rate, interest rates have tended to come down. Every time they have lost control and the money supply has grown very rapidly, interest rates have gone back up. The most recent instance, of course, was last December and January when the money supply expanded too rapidly.

So there is support from that point of view and believe me, this is something worrying the market very, very much.

I hope President Reagan did something yesterday to lay this to rest in sort of declaring peace with the Federal Reserve over this discussion.

I think Mr. Evans' comment there was very, very appropriate.

The administration's view with respect to interest rates was that the decline in inflation would result in lower interest rates. They

also argued, and I think correctly, that we could expect a fairly significant increase in the rate of personal saving as we moved through this period.

West Germany and Japan both have larger deficits than ours. Why don't these countries have more inflation? The simple answer is that both countries have rates of personal saving that are far higher than ours.

The personal savings rate in the United States has been very low, averaging only 5 to 5½ percent of disposable income in recent years. We should move that rate back up to around 8 percent, the level that prevailed in the first half of the 1970's. Each one percentage point increase in the personal savings rate affords $20 billion of additional saving which can help offset $20 billion of dissaving in the form of a Federal deficit.

A three-point increase in the savings rate means $60 billion in more savings. That would pretty well nullify $60 billion of the Federal deficit at least in the short run.

The shape of the 1981 personal tax cuts was such that they should generate more individual saving because the tax cuts were proportionate to the way people were paying taxes and the tax cuts are larger for people that saved more of their income.

Furthermore, this committee, particularly Representative Moore, is to be strongly commended for efforts in support of liberating the individual retirement account. I think the expanded IRA's will encourage a substantial response and help move the savings rate up to a higher level. Banks, thrift institutions, mutual funds, and insurance companies are all establishing very attractive IRA's to encourage individuals to save.

Furthermore, as the inflation rates come down, the temptation to invest in real assets like condominiums, gold, silver, works of art, and so forth, declines because the rate of return on most of those assets is purely inflation. As a result, people will move from real assets into financial assets like stocks and bonds. As people buy bonds, the price of bonds goes up and interest rates go down. What I am talking about is purely an expectational effect. It doesn't require any more saving. It is just a shift in attitudes, and that too should happen sooner or later.

The critics, on the other hand, argue that our problem is almost solely in the form of these huge deficits which we see coming down the road. They expect a collision between Federal Reserve policy and fiscal policy in the form of deficits, and as a result, very high interest rates.

Who is right, the administration or its critics?

Given our experience with deficits relative to GNP over the past decade or so, and the experience of other countries' deficit-to-GNP ratio, I don't think we should be too concerned about a deficit that averaged 3 to 4 percent of GNP, if we can raise our savings rate.

I think we could finance a deficit averaging 3 to 4 percent of GNP without monetization of too much debt. However, there are several problems. First, there is the danger that these deficits may exceed 4 percent because the estimates are somewhat on the conservative side, according to some observers.

Second, deficit financing as a way of life is, in my view, very bad public policy. It destroys the benchmark. It destroys the measure

that keeps the Federal sector from growing too much. That is what got us into this mess in the first place.

Third, as Prof. Martin Feldstein said to this committee yesterday, Federal deficits mean the Government is borrowing money which cannot than be used by the private sector.

Thus, reducing the deficit means more funds are available for business investment and consumer purchases of homes, automobiles, and so forth. In addition, there is no question that high interest rates are impeding economic recovery.

For these reasons, I think the economic game plan should now be adjusted. I think we have to move to cut near-term deficits and, while I would not set a target year, I think we must move toward a balanced budget. However, we need not and should not disturb the basic framework of Reaganomics.

The tax and budget measures passed by Congress last year were absolutely appropriate and long overdue. To me, the question now is one of timing. We must restore the balance between the rate of reduction in Federal spending relative to GNP and the rate of reduction of taxes. This adjustment in the economic game plan should be negotiated between Congress and the administration in a spirit of compromise, on a bipartisan basis.

At this point I will turn to page 6 of my formal statement.

Any adjustment in the Reagan administration economic game plan should and can honor its central thrust—the drive to reduce the rate of growth of the Federal sector, the size of the tax burden and its impingement on incentives, and overregulation of business activity.

With respect to the first of these, major attention should be focused on Federal spending relative to GNP rather than on an attempt to achieve a given Federal deficit in any fiscal year. With any year's deficit subject to wide and sudden swings as a result of only small changes in interest rates, unemployment, and the rate of economic growth, the deficit as a target is all too often a will-o'-the-wisp.

The proper target was enunciated by candidate Ronald Reagan, as I noted, in his call for personal and business tax cuts in June 1980, when he said that such cuts should be accompanied by a steady reduction in Federal spending relative to GNP.

He reiterated this point in a speech on September 9, 1980, when he stated that his 5-year goal would be to bring the ratio of Federal spending to GNP down from the 23 percent then prevailing to the 18- to 19-percent level that prevailed when economic growth was strong and prices reasonably stable.

The impact of the current recession and high interest rates on budget spending has pushed the ratio to an estimated 24.2 percent, including off-budget items, in this fiscal year, but the Reagan budget would restore the downward trend thereafter. Projections are for 22.5 percent in fiscal year 1983, 21.6 percent in 1984, and 21.1 percent in 1985.

As its major contribution to the adjustment in the economic game plan, Congress should hold the total of on- and off-budget spending in fiscal year 1983 to the $773 billion requested by the President. That is $757.6 billion of on-budget spending, or 21.1 percent of the administration's GNP forecast.

For his part, the President should agree to steps that would significantly increase revenues and reduce deficits in 1983 and beyond. There are several options for the President and Congress to consider. Of these, I would like to discuss three productive steps.

The first and most attractive option is in connection with deregulation of natural gas. I would like to see the President state that he favors orderly, complete and speedy deregulation of natural gas as an important component of the administration's policy of deregulation of business activity, even if—as is generally believed—such decontrol would be approved by the Congress only in connection with the levying of some sort of severance tax on natural gas.

Gas decontrol accompanied by an excise or severance tax would not only help reduce the large deficits we face, but would also yield other benefits to our economy.

First, gas decontrol would serve the dual goals of stimulating exploration and promoting conservation by consumers and industrial users.

Both Government and private studies show that gas supplies will decline by 1985 if the pricing regulations of the Natural Gas Policy Act of 1978 are not modified.

Second, decontrol phased in now over a period of several years would avoid the sharp gas price increases expected in 1985 under the NGPA; Government estimates indicate that wellhead prices will jump by 70 percent in 1985 if the present law is not changed.

In addition, decontrol would eliminate the inequitable discrepancies in gas prices across the country. Some users pay an average of $2.50 per thousand cubic feet, while others pay $5 or more per thousand cubic feet.

Other advantages of early decontrol include a reduction of oil imports and, therefore, less vulnerability to oil supply interruptions.

One approach to phasing out price controls is to immediately decontrol newly discovered gas and phase out price regulations on all other gas in 3 to 5 years.

The across-the-board tax could be made effective as of January 1, 1983, and expire at the end of the decontrol period. Revenues raised would depend on the rate of tax, but should be targeted at a minimum of $10 billion per year.

I am talking about an across-the-board severance tax that doesn't distinguish between types of tax. Second, there are additional energy-related fees which could reduce the size of the deficit. A tariff of $5 per barrel on imported oil and refined product would, according to the Congressional Budget Office, raise about $17.5 billion annually.

The tariff on imports would not only raise revenue, but also tend to depress the level of imports, thereby reducing our vulnerability to supply cutoffs.

Domestic as well as imported oil prices would reflect the impact of the tariff; higher prices for oil would encourage the substitution of coal, natural gas, and other fuels for oil.

While there may be a short run impact on inflation as the economy adapts to higher oil prices, the advantages of reducing the size of the deficit and improving our national security by lessening our dependence on imported oil outweigh the temporary price level

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impact. Moreover, the existing world oil glut would help minimize the extent of the pass-through of the import fee to consumers.

This fee should also terminate in 3 to 5 years. Termination dates for both measures will not only help assure that the measures do not become permanent; they will also focus the higher revenues at the time defense spending is expanding most rapidly and the projected deficits are the highest.

Third, if additional revenues are needed to narrow future deficits, consideration should be given to delay—not suspension, only delay—of all or part of the 10-percent individual income tax cut scheduled for July 1, 1983. A delay of the entire tax cut for 1 year would raise revenues by an estimated $9 billion in fiscal year 1983 and an additional $27 billion in fiscal year 1984. If the delay were extended until January 1, 1985, the fiscal year 1984 deficit would be reduced by $37 billion by that action alone.

The impact on financial markets of steps such as these would be dramatic. Experts believe that if financial market participants were convinced that the steps taken were in earnest, and this would require a strong bipartisan consensus in the Congress, interest rates would decline sharply.

The prospect for short-term economic recovery would be greatly strengthened, and the door opened for the increased business investment spending that is the key to restoration of long-term economic expansion.

Let me conclude by saying that President Reagan is, in my view, correct in his determination to stay on course in applying his economic game plan, and in this determination he has strong support in Congress and among the American people.

In this respect, it is important to understand that bipartisan agreement, and I repeat that this agreement is of crucial importance to achieving positive performance in financial markets—to select from the menu of revenue-raising measures discussed herein would not represent any compromise with the fundamental principle of Reaganomics.

Even if the final installment of the individual tax cut were delayed, the entire tax program would still be effected within the 5 years which was the original target for the administration.

Moreover, the tax reductions plus reaffirmation of spending restraint by meeting the President's "mark" for fiscal year 1983—and this is also crucial for the positive impact on financial markets—would mean that the Nation would still be solidly on course in reducing the relative size, burden, and obtrusiveness of a bloated Federal sector.

Both fiscal legs of Reaganomics—reduction in the ratio of Federal spending to GNP and easing of the tax burden—are crucially important. For maximum success, both need to be phased in together at approximately the same speed. Under the program adopted in 1981, tax reduction will quickly outrun spending restraint.

This is an imbalance that, through a bipartisan approach, can and should be corrected.

[The prepared statement follows:]

STATEMENT OF DR. CHARLS E. WALKER

Mr. Chairman and Members of this Distinguished Committee: My name is Charls E. Walker. I am chairman of Charls E. Walker Associates, Inc., a Washington-based consulting and representational firm. I am also voluntary chairman of the American Council for Capital Formation and a member of the President's Economic Policy Advisory Board. However, today I am testifying only for myself.

I am grateful for the opportunity to present to the committee my views on the past, current and prospective economic scene. This I shall do by describing the basic problems that existed when the Reagan Administration took office; the "game plan" that the Administration offered—and Congress accepted—to deal with that problem; and whether there is currently a need for an adjustment in that game plan.

THE ECONOMIC PROBLEM IN 1981

As the 1970's drew to an end and we entered the 1980's, this nation's fundamental economic problem was that of "stagflation"—inflation at double digit levels in an economy plagued by stop-go performance, sluggish real growth, and too-high levels of unemployment. Fortunately, a consensus had emerged as to the root cause of this problem, namely, a Federal sector that had grown very rapidly during the decade and was absorbing a high and ever-growing proportion of the nation's economic resources.

A good measure of this absorption is the ratio of Federal spending (including off-budget outlays) to gross national product. During the high-growth, low-inflation years of the 1950's and 1960's, that ratio (with two exceptions) averaged from 17 to 19.5 percent. Then the ratio shot up from just over 20 percent in fiscal year 1970, to 22.5 percent in fiscal year 1975, and to 23.7 percent in fiscal year 1981. On the basis of Administration assumptions and budgeted spending levels, the ratio is expected to top out at 24.2 percent in the current fiscal year and decline thereafter.

Rapid growth in Federal spending fostered inflation in at least two ways. First, the transfer payments that made up a substantial portion of the increase in outlays represented a shift in resources from the more productive to the less productive sectors of society. Second, with middle-income taxpayers increasingly unwilling to fund the rapid increase in outlays, chronic deficits emerged. With a firmer monetary policy—and, of course, even higher interest rates—it would have been possible to finance these deficits in a non-inflationary manner, i.e., by borrowing genuine savings. But the fact is that too large a portion of the deficit was indirectly monetized by Federal Reserve purchases of government securities in the open market. Monetary growth was excessive and the price level shot up.

As Federal spending rose, taxes went up also, but not by enough to assure balanced budgets. At 21 percent of GNP in fiscal year 1981, Federal tax receipts were at the highest ratio since World War II. This heavy tax burden contributed to stagflation through its impact on incentives to work, save and invest, and especially through the negative impact on productivity.

The heavy tax burden was especially inimical to solid economic growth because of its distribution. Reflecting outmoded economic theories that emerged during the Great Depression, the existing tax system as we entered the 1980's was biased heavily in favor of consumption and against productive saving and investment. For individuals, the high marginal rates that seemed justified to some people in earlier times as good social policy sharply impinged on incentives for individuals to work, save and invest; they also generated the "bracket creep" that seems so unfair to the middle-income Americans who pay the lion's share of individual income taxes. High business taxes depressed capital formation and productivity by reducing the rate of return to new investment and cutting the cash flow available to finance that investment.

Taken together, rapidly rising Federal spending and a mounting tax burden constituted the twin and major economic evils that plagued this country in the decade of the 1970's and promised even deeper trouble in the 1980's and beyond.

THE REAGAN ECONOMIC GAME PLAN

The Reagan Administration attacked these evils directly. Its 1981 program of budget restraint, approved by Congress, sharply reduced the rate of growth in Federal spending in fiscal year 1982; further cuts in the growth rate of Federal spending have been proposed for fiscal year 1983 and beyond. Massive tax legislation reversed the upward trend in taxes relative to GNP and also strenthened incentives to work, save and invest, and for business concerns to purchase new productive equipment. These steps, coupled with a retreat from over-regulation of business activity

and strong moral support for a Federal Reserve policy of slower and more stable monetary growth, constituted what the press has called "Reaganomics."

It is far too early to judge the success of this program. Progress in dealing with Public Enemy No. 1—inflation—has exceeded expectations and, indeed, is the most significant single development of the past year. But, with inflationary expectations deeply imbedded, the return to a non-inflationary environment was bound to take time and involve hardship. That hardship arrived in 1981 in the form of recession, with output dropping sharply and unemployment approaching 9 percent. Interest rates, which Administration policymakers expected to fall as inflation receded, remained stubbornly high, threatening the timing and strength of recovery from the recession.

"Real" interest rates—i.e., market rates less the expected rate of inflation—are at very high levels. According to one school of thought, these high rates—particularly for long-term securities—reflect market fears that, despite their protestations to the contrary, Federal Reserve authorities will sooner or later cave in to political pressure and unduly inflate the money supply to help fight recession and unemployment. Financial market skittishness in this respect is demonstrated by experience over the past two years—each time the rate of monetary expansion has moved above Federal Reserve target ranges, interest rates have tended to go up, but when monetary growth has stayed within bounds, interest rates have come down.

Administration policymakers argue that lower inflation rates must ultimately result in lower interest rates because the inflationary premium which became incorporated into rates in the 1970's will sooner or later be wrung out. They also maintain that the personal saving rate, which has averaged only 5.4 percent of disposable income over the past few years, will rise to at least the 8 to 8½ percent range that prevailed during most of the first half of the 1970's. Following the Kennedy-Johnson tax reductions in the first half of the 1960's—on balance, a very good supply side tax cut—the personal saving rate rose sharply. The Reagan tax cuts on individuals are concentrated on people who do the most saving, and the new Individual Retirement Accounts constitute a major pro-saving force. With each percentage point representing $20 billion in saving, the potential contribution of an increase in the personal saving rate to non-inflationary financing of Federal deficits is obvious.

But, say critics, Federal deficits looming in the next few years are simply too large; they think it is fear of these deficits that is keeping interest rates high and threatening economic recovery. Such deficits, say the critics, will collide with anti-inflationary monetary policies and the only possible result will be high interest rates and "crowding out" of private investment.

Who is right—the Administration or its critics? My view is that Federal deficits which do not exceed four percent of GNP can probably be financed without excessive monetary expansion. But deficits in the next few years threaten to rise significantly above that percentage. Moreover, financial markets quite clearly believe that the deficits now in prospect spell trouble, thus impeding the decline in interest rates justified by the improved outlook for inflation.

In addition, deficit financing as a way of life is bad public policy. It removes a practical limit on growth of the Federal sector—and remember, it is that growth that got us into this mess in the first place. Chronic deficits also rob financial markets of funds that could otherwise be used to support the capital formation this country so badly needs.

An adjustment to the economic game plan that will sharply cut near-term deficits and return us to a balanced budget relatively soon is therefore urgently needed. This correction need not at all disturb the basic framework of Reaganomics that the Administration and Congress put in place last year. It is an adjustment that should be negotiated between the Congress and the Administration, in a spirit of compromise, on a bipartisan basis.

THE GAME PLAN ADJUSTMENT

Any adjustment in the Reagan Administration economic game plan should and can honor its central thrust—the drive to reduce the rate of growth of the Federal sector, the size of the tax burden and its impingement on incentives, and over-regulation of business activity. With respect to the first of these, major attention should be focussed on Federal spending relative to GNP, rather than on an attempt to achieve a given Federal deficit in any fiscal year. With any year's deficit subject to wide and sudden swings as a result of only small changes in interest rates, unemployment, and the rate of economic growth, the deficit as a target is all too often a will o' the wisp.

The proper target was enunciated by candidate Ronald Reagan in his call for personal and business tax cuts in June 1980, when he said that such cuts should be accompanied by a steady reduction in Federal spending relative to GNP. This point he reiterated in a speech on September 9, 1980, when he stated that his five-year goal would be to bring the ratio of Federal spending to GNP down from the 23 percent then prevailing to the 18 to 19 percent level that prevailed when economic growth was strong and prices reasonably stable. The impact of the current recession and high interest rates on budget spending has pushed the ratio to an estimated 24.2 percent in this fiscal year, but the Reagan budget would restore the downward trend thereafter. Projections are for 22.5 percent in fiscal year 1983, 21.6 percent in 1984, and 21.1 percent in 1985.

As its major contribution to the adjustment in the economic game plan, Congress should hold the total of on- and off-budget spending in fiscal year 1983 to the $773 billion requested by the President, or 22.5 percent of the Administration's GNP forecast. For his part, the President should agree to steps that would significantly increase revenues and reduce deficits in 1983 and beyond. There are several options for the President and Congress to consider.

The most attractive is in connection with deregulation of natural gas. I would like to see the President state that he favors orderly, complete, and speedy deregulation of natural gas as an important component of the Administration's policy of deregulation of business activity, even if—as is generally believed—such decontrol would be approved by the Congress only in connection with the levying of some sort of severance tax on natural gas.

Gas decontrol accompanied by an excise or severance tax would not only help reduce the large deficits we face but would also yield other benefits to our economy. First, gas decontrol would serve the dual goals of stimulating exploration and promoting conservation by consumers and industrial users. Both government and private studies show that gas supplies will decline by 1985 if the pricing regulations of the Natural Gas Policy Act of 1978 are not modified. Second, decontrol phased in now over a period of several years would avoid the sharp gas price increases expected in 1985 under the NGPA; government estimates indicate that wellhead prices will jump by 70 percent in 1985 if the present law is not changed. In addition, decontrol would eliminate the inequitable discrepancies in gas prices across the country; some users pay an average of $2.50 per thousand cubic feet (mcf), while others pay $5.00 or more per mcf. Other advantages of early decontrol include a reduction of oil imports and, therefore, less vulnerability to oil supply interruptions.

One approach to phasing out price controls is to immediately decontrol newly discovered gas and phase out price regulations on all other gas in three to five years. The tax could be made effective as of January 1, 1983 and expire at the end of the decontrol period. Revenues raised would depend on the rate of tax, but should be targeted at a minimum of $10 billion per year.

There are additional energy related fees which could reduce the size of the deficit. A tariff of $5.00 per barrel on imported oil and refined product would, according to the Congressional Budget Office, raise about $17.5 billion annually. The tariff on imports would not only raise revenue but also tend to depress the level of imports, thereby reducing our vulnerability to supply cut-offs. Domestic as well as imported oil prices would reflect the impact of the tariff; higher prices for oil would encourage the substitution of coal, natural gas and other fuels for oil. While there may be a short run impact on inflation as the economy adapts to higher oil prices, the advantages of reducing the size of the deficit and improving our national security by lessening our dependence on imported oil outweigh the temporary price level impact. Moreover, the existing world oil glut would help minimize the extent of the pass-through of the import fee to consumers.

This fee should also terminate in three-to-five years. Termination dates for both measures will not only help assure that the measures do not become permanent; they will also focus the higher revenues at the time defense spending is expanding most rapidly and the projected deficits are the highest.

If additional revenues are needed to narrow future deficits, consideration should be given to delay—not suspension, only delay—of all or part of the 10-percent individual income tax cut scheduled for July 1, 1983. A delay of the entire tax cut for one year would raise revenues by an estimated $9 billion in fiscal year 1983 and an additional $27 billion in fiscal year 1984. If the delay were extended until January 1, 1985, the fiscal year 1984 deficit would be reduced by $37 billion.

The impact on financial markets of steps such as these would be dramatic. Experts believe that if financial market participants were convinced that the steps taken were in earnest—and this would require a strong bipartisan consensus in the Congress—interest rates would decline sharply. The prospect for short-term econom-

ic recovery would be greatly strengthened, and the door opened for the increased business investment spending that is the key to restoration of long-term economic expansion.

CONCLUSION

President Reagan is correct in his determination to stay on course in applying his economic game plan, and in this determination he has strong support in Congress and among the American people. I this respect, it is important to understand that bipartisan agreement—and I repeat that this agreement is of crucial importance to achieving positive performance in financial markets—to select from the menu of revenue-raising measures discussed herein would not represent any compromise with the fundamental principle of Reaganomics. Even if the final installment of the individual tax cut were delayed, the entire tax program would still be affected within the five years which was the original target for the Administration. Moreover, the tax reductions plus reaffirmation of spending restraint by meeting the President's "mark" for fiscal year 1983—and this is also crucial for the positive impact on financial markets—would mean that the nation would still be solidly on course in reducing the relative size, burden and obtrusiveness of a bloated Federal sector.

Both fiscal legs of Reaganomics—reduction in the ratio of Federal spending to GNP and easing of the tax burden—are crucially important. For maximum success, both need to be phased in together at approximately the same speed. Under the program adopted in 1981, tax reduction will quickly outrun spending restraint.

This is an imbalance that, through a bipartisan approach, can and should be corrected.

Mr. PICKLE. We thank you, Mr. Walker. I take it that the thrust of you gentlemen's statement is that we have huge deficits, and when you view them as a figure or when, in connection with the GNP, that something has to be done with the deficit.

Most of you have said the President ought to stay on his course, but you want to make some adjustment.

Do any of you believe we in the Congress should not make any changes basically, but stay on course?

Do any of you think we should not, for instance, make some adjustment, or delay in the individual income tax reduction for 1983?

Do any of you think that is an area that we cannot touch? Do you want to stay on the course?

For example, do any of you think we should not consider some adjustment in that third year phase of the individual tax reduction?

Mr. BECK. Mr. Chairman, I think one of the things that all four of us said was that we need consistency. We need to be able to look forward with some certainty as to what is going to happen.

I don't think it is so much a question of whether the tax should or not be reduced, but if Congress and the administration would make up their mind and agree on something and then live with it so we can look ahead, I think that is the important thing.

If it is going to be done, you are going to make changes, I think it ought to be done promptly and it ought to be done with some certainty that it is going to last, and not change again next year.

Mr. PICKLE. Would anyone else want to comment?

Mr. BEACH. Yes. I would merely add that if that were perceived as a minor adjustment and not a basic change in policy, and if it were also accompanied by some reasonable increases in revenues and by other spending cuts—and where the increases in revenue did not eliminate increased investment—it would be all right.

Mr. PICKLE. The President recommended no new taxes. He has made that point many times, although in his budget message, he

does include a $12.7 billion raise in taxes. But he still says he wants no increase in taxes.

Now you are saying we have to consider new revenue raisers. So I assume none of you said that we can ignore the third year tax cut; that it ought to be considered. We ought to stay on the course, but the fact of the matter is, we can't feed the American people just by staying on course.

I take it you think what we did was right; it was the right kind of business investment, but that we have a cost overrun, and now we have to adjust to it. Is that an unfair analysis to make?

Mr. EVANS. I think that is fair, Mr. Pickle, but I think what we also are all saying, and what Mr. Blumenthal said earlier, and we know it is very, very difficult politically, but we would believe that the leadership needs to face the problem of costs of entitlements, just not to take anything away now, but the continued growth.

We know that is very hard for you to do, but that is extremely costly and therefore that goes to the expense side which we would believe you should, and we know you will continue to look at very carefully.

Mr. PICKLE. Well, I know that most of you say we ought to raise new revenue. Cut spending, but raise some new revenue, so you are saying to us, this is one avenue that we ought to look into, make the best choice we can make from the menu, try to raise new revenue.

Mr. Walker, I am surprised you are recommending a windfall profit tax.

Mr. WALKER. No; my preference is an across-the-board severance tax, not a windfall profit tax. The tax would not be related to the differential prices of gas for different categories. I think we have to get rid of those different categories.

An across-the-board severance tax would be simple to administer and easy to do.

Mr. PICKLE. Well, it is going to be called a windfall profit tax. You can perfume it with a little Texas aroma, but it is going to be a windfall profit tax.

I am rather surprised you would recommend it.

Mr. WALKER. I think it is very important to deregulate natural gas. Unless we make needed modifications to increase gas supplies and avoid sharp price increases, we face a very tough situation in 1985.

Mr. PICKLE. You are also recommending a $5 a barrel import fee on oil.

Mr. WALKER. Right.

Mr. PICKLE. Does this come from the API? Do they recommend this?

Mr. WALKER. I don't have any idea.

Mr. PICKLE. I rather imagine you have an idea.

Mr. WALKER. No. I——

Mr. PICKLE. Does this come from the Texas Independent Petroleum & Royalty Owners Association?

Mr. WALKER. No; this comes from Charly Walker. It is an idea that many people have been talking about for several months.

Mr. PICKLE. Do you think we could have this severance tax and put it on for 2 or 3 years?

Mr. WALKER. Yes.

Mr. PICKLE. Well, you are not as far out as I thought you were, Mr. Walker.

With the new federalism cuts underway that will be financed by a trust fund, 60 percent of which will come from the windfall profit tax on oil, now you add imported oil. Do you think we would start this program in 2 or 3 years and then take it off? It will be with us forever.

Mr. WALKER. I did not suggest it be permanent.

Mr. PICKLE. That is what you are suggesting.

Mr. WALKER. No; I am not. This is to reduce the deficit.

Mr. PICKLE. I am not going to argue with you. I am just saying to simply recommend decontrol is also to recommend a windfall profit tax or severance tax.

Mr. WALKER. This gets back to the basic point I want to make in connection with the question you addressed to the entire panel. I am not for a minute about to endorse consideration of any delay of the 1983 tax cut unless we can have an ironclad compact that that delay is not going to be translated into increased spending.

We have to go down that curve of Federal spending relative to GNP, so if you took part of the severance tax and put it into a trust fund to support some spending that would be a direct violation of what I have suggested.

Mr. PICKLE. I was impressed by your statement. You say we ought to have a delay and not a suspension. At least you are saying that is an area we can legitimately look at.

Mr. WALKER. Yes.

Mr. PICKLE. You would raise $27 billion from the oil and gas industry to finance this deficit, but at the same time you would say we could perhaps delay the third year tax cut.

Mr. WALKER. I am saying more than that.

Mr. PICKLE. Most of you are saying that is a possibility but to the extent we can all agree, yes, it ought to be just a delay and not a suspension.

Mr. WALKER. I am saying more than that. As far as I am concerned, the modifications I have outlined this morning do not violate the fundamental principles of the policies President Reagan recommended and Congress adopted last year.

It is entirely a matter of timing. It is completely within the 5-year framework of the game plan that was developed in the campaign and later presented to the Congress.

Mr. PICKLE. We have to make some changes to pull down our deficit. I hope we can do it in a way that will be best for business. Now, the Chair recognizes Mr. Anthony for questioning.

Mr. ANTHONY. Thank you, Mr. Chairman.

Mr. Walker, I would like to thank you for at least pointing out one thing. I would like to bring Mr. Beach's attention to it on page 7 of his testimony.

Maybe the two of you can get together and correct any contradiction that is in there. The statement says, "In this context it must be stressed that the deficit we face is in large part the result of tax reductions, not increases in government spending."

And I had several questions to ask along that point. But I think you have made it very clear on page 6 of your testimony, Mr. Walker, that the deficit that we have is as a result of spending.

As a percentage of GNP, it rose in 1980 to 23.7 percent in 1981 and a projected 24.2 percent in 1982 as you mentioned.

That was from 23 percent in 1980. What I am a little bit confused about is, I guess what I have been hearing the business community say for the last 2 months, as I travel across this country on field hearings with the Ways and Means Committee.

I have gone back into my district. I have talked to the business community. In private, they tell me that we need to cut defense and cut defense fairly significantly. Secretary Blumenthal, I thought, laid out a very reasonable plan where we could have increased growth and still cut it maybe $10 billion plus.

They also say we need to raise taxes, but they also say that they totally and 100 percent support the President's program.

Right now, today, Mr. Evans says he supports the President's program. Mr. Walker still supports the President's program, but Evans says he is willing to cut defense.

Mr. Walker says as part of a total package he is willing to postpone the July 1, 1983 tax cut. When is the business community going to surface publicly and tell the President that they are willing to support his program only when it is amended in order to bring down the deficit?

Right now it is all behind the scenes. When is the business community going to rise publicly and encourage the President to come forth and to compromise with this Congress in a bipartisan effort to accomplish exactly what we all want to accomplish?

I think your testimonies, taken individually and jointly, make a great deal of sense. It says exactly what the business community has been telling me. But that feeling has not been enunciated by the President himself. He has written a letter to the Congress, after Mr. Stockman was down here testifying, saying that Defense is off limits, and any tinkering with the personal income tax, either a postponement or suspension for 1 day, is off limits.

So, until we have a better accord coming out of the President's Office, out of the White House, I don't see that we are going to be able to have that bipartisan constructive debate in the Congress. So my question simply is this: When will business surface publicly, united, and tell the President that they will support him, they still believe in his program, his goals, but are they going to lobby the Congress to make some short-term adjustments?

Mr. EVANS. I think it is just a matter of timing, Mr. Anthony. This budget has just arrived. In the small business community Mr. Beck represents, there are tens of thousands of businesses and tens of thousands of businessmen, hundreds of thousands, it takes a good long time for this to trickle through for a consensus to develop.

We have all said we are very concerned and we are speaking mostly for ourselves, but we believe we represent the general trend of business thinking.

The President just yesterday, and the President in the last 2 or 3 days or in the past week, seems to indicate that he is more receptive, as he talked about running room that he would give the Con-

gress, and he seems to refer to the fact that he is very acceptable or reasonable to proposals.

I think it is probably going to come. It is just a little early.

Charlie, do you agree with that?

Mr. WALKER. I think probably so. I think, first of all, they have my statement at the White House, my views as to this position are on record.

Mr. ANTHONY. Mr. Walker, I want to compliment you for laying out a very constructive, although controversial, solution to the problem. Every program that we offered to solve the problem is going to be controversial, so we will take the best of a bunch of controversial programs and try to go home and sell them politically.

I admire you for laying it on the table.

Mr. WALKER. The energy taxes I outlined are fully justified on their own merit. They are certainly justified from the standpoint of energy policy. In addition, any delay in the 1983 tax cut, as far as I am concerned, is simply a timing matter and not a violation of basic principles.

I can't speak for the administration, but I think they have proposed a budget and must now look to the reaction in Congress.

What are you fellows going to say about it?

Mr. ANTHONY. We have said we don't like the deficit and would like to have a solution. I want to thank all of you.

I thought you made some excellent points and I hope you will continue to work with the committee.

But more importantly, and I have made this speech to many of my business people back home, that if they want a $150 billion deficit, that is exactly what they will get.

If the business community is not willing to surface publicly and put the pressure where it is going to have to be put to make the parties compromise, they will get a $150 billion deficit this year and in the out years.

If you think you are on the right course, gel up quickly and let's start moving forward.

Mr. PICKLE. Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman.

Mr. Walker, in the course of giving advice to the President, did you advise him to cut deeper in the areas of AFDC, medicaid, health, housing, unemployment, training, education, student loans?

Mr. WALKER. I have not. I don't consider myself an expert in those particular areas. My point is that this rate of increase in Federal spending has to be reversed.

Mr. RANGEL. Assuming we agreed with you that we had to stop this rate of increase in Federal spending, do you believe that we over-did it in the areas we did cut?

I mean, you are not an expert, but you can imagine, I assume, the dreams that are shot for those people who are unemployed. You have old folks that need health care, and then the President comes back and asks for even more devastating cuts. While the President followed your advice to relieve tax burdens for the wealthier Americans, would you suggest that the administration take another look and reflect on the impact that the President's policies are having on the poor and working people of this country?

Mr. WALKER. The President could reflect on that. All I have seen thus far in terms of the real impact of this on the public consciousness is a steady diet from the Washington and New York papers and the television networks of individual anecdotal horror cases. These don't do any good in trying to understand what the impact actually is.

Mr. RANGEL. Mr. Walker, we didn't read the Times and the Post. We went to the field and we saw soup lines and unemployment lines. These were people who had worked all their lives and they were now receiving free food from charitable organizations in Seattle. This is a very sad thing.

Mr. WALKER. These were unemployed people?

Mr. RANGEL. Of course.

Mr. WALKER. That is the point. We are in a recession.

We are in a recession, partly as a reaction.

Mr. RANGEL. We have cut back training. These are people who want to work.

Mr. WALKER. I know, and the best way to get them to work is to get out of this recession. The recession is here in part because of the policies we have had over the past decade or so.

To make matters worse by increasing Federal spending is not the way you are going to cure it. It is the palliative that makes it worse in the long run. In the long run, you are helping the people by getting the bloated Federal sector under control.

I think the vast majority of the public recognizes that.

Mr. RANGEL. You think the public that is not working appreciate what we are doing to them?

Mr. WALKER. I think you have to study the last three decades of Federal policy to understand what has caused us to be in this very undesirable situation now.

Mr. RANGEL. Assuming someone has worked for the last three decades, you say that they generally understand why student loans for their kids and housing programs are being cut, and in general they are included in a group that believe this policy is best for them?

Mr. WALKER. I can't speak for them. I have seen on T.V. some who said, yes, it was basically a good policy, and others who said it was horrible.

Mr. RANGEL. Do you think that Congress is going to support cuts in the areas we are discussing now?

Mr. WALKER. I don't know.

Mr. RANGEL. Do most members of the panel agree with the remarks of Mr. Walker?

Mr. BECK. I met the other day with undergraduates in my university, and a couple say, we are not getting food stamps anymore. I don't know why we got them in the first place. Now they are cutting them out, it is fine for me, why did we get them in the first place.

In northern New Jersey——

Mr. RANGEL. I go along with Dr. Walker's suggestion that there are horror stories in the Washington Post and the New York Times, but my God, how do you and Mr. Reagan confine the horror stories to the welfare mothers driving around in pink Cadillacs and college students? If we were talking about getting rid of fraud,

waste, and abuse, that is one thing, but these stories are the rare exception.

You don't mean to testify that the impact of the reduction in food stamps is just going to adversely affect kids in college who don't need them.

Then you could say unemployment compensation is for people working and health care is for well people and that consequently the Nation is abusing the system.

I suspect you would be prepared to improve the quality of life for people dependent on food stamps? Of course not.

We want to cut Federal spending and it seems that the most convenient way to do it is to take from the people who are the least powerful in the community. I hope that since you are not locked into cement with the third-year tax cut and not locked into cement on the question of the defense budget that some of you might have realized that it is not just the Times and the Washington Post, but it is tens of millions of people in this country who really believe that this program has been disproportionately unfair. This is clear when we take pride in saying we are relieving the tax liability of the wealthiest people in this country.

I don't believe there is equity involved in it at all.

Mr. PICKLE. Mr. Matsui.

Mr. MATSUI. Assuming we don't do the kinds of things that you are suggesting in your statement, and I see most of them as somewhat unlikely—even though it might be proper to make some of your adjustments—and assuming we adopt the budget and that budget is probably in the range of $120–$125 billion, rather than $91 billion, when do you think we will move out of this recession?

Mr. WALKER. The assumption is that some modifications must be made.

Mr. MATSUI. We adopt the President's budget intact with a deficit of instead of $91 billion, $120 to $125 billion, which is a more realistic figure.

Mr. WALKER. I am not going to sign off on that figure. The answer to the size of the deficit depends largely on how soon the economy comes out of the current recession.

Mr. MATSUI. Assume that Mr. Volcker is going to continue his money supply range of 2½ to 3 percent, probably on the high side of that, as he indicated?

Mr. WALKER. The odds favor recovery starting in the spring of the year, as I have felt all along. When you have figures like in the past week of the industrial production in January, which was impacted by the weather, people look at something that happened six weeks ago and say, he will never get recovery.

In every recession we have had since World War II, we have never recognized the recovery until it was already underway. I still think the prospects for recovery in the spring are promising. However, the recovery isn't going to be as strong as it should be unless we have declining interest rates.

Mr. MATSUI. Assuming that we adopt the President's budget, what is going to happen to the interest rates in the spring?

Mr. WALKER. I think the overall trend of interest rates is going to be down, given the prospect for inflation and given the prospect

for increased savings. But in terms of having as strong and vigorous a recovery as we might otherwise, let me raise another point.

I don't want to get too arcane, but look at what the markets are saying about the prospects for continued inflation. There are new instruments in the market known as interest rate futures that haven't done that badly. This means that people taking a longer view are not that pessimistic about interest rates, but if they don't come down, we won't have as strong a recovery as we should have.

Mr. ANTHONY. Would the gentleman yield? Something that was touched on in some of your testimony, but I don't think has been made prominent in any of the hearings, and that is long-term interest rates of corporate utilities, tax-frees and of the last 30-year bond sale by the Federal Government.

All of those have hit historic highs and at some points, exceeded short-term interest rates. That is money that is locked in.

Somebody made a special point of it, but if you have any special medicine there, that is the one that bothers me.

I appreciate you yielding.

Mr. BEACH. I think the biggest factor in those long-term interest rates is inflation expectations, and if there is a possibility of bringing down Government spending, and as we come out of the recession, I think those interest rates will move down significantly.

We noticed that in our business: the fact that we don't have a large cashflow in the life insurance business that would allow us to invest in long-term bonds reflects the fact that individuals want to buy term insurance, where there is no accumulation for investment funds.

In the pension area people are also investing in things which will hedge against inflation. When people cease to be concerned about inflation, and cease to expect profits because of increases in prices, they will be more satisfied to buy long-term bonds—and interest rates will go down.

That is what business needs, to be able to finance based on long-term bonds with assurance as to what their capital is going to cost them.

They can't do that now. That is the problem.

Mr. MATSUI. With respect to your issue of savings, you expect people to save that tax cut basically, the one that will come into effect in July?

Mr. WALKER. It depends on their income level and their savings habits. I think there will be a great deal saved.

Mr. MATSUI. Those making over $50,000 will save and those that make less——

Mr. WALKER. No, there seems to be an indication that below $15,000 to $20,000 of family income, the savings rate is probably negative, that people go into debt. Above $15,000, the savings rate becomes increasingly positive.

Mr. MATSUI. I find that hard to believe because with the contracts now being negotiated, you are not seeing that large of a wage increase, and so where are they going to get the money?

They are barely making it now at $20,000, $25,000, $30,000 for a family of four, so where do they get the money to save? It is not a tax cut for most people, it is just keeping even with the inflation rate.

Mr. WALKER. Those people whose incomes are in the range of $15,000 and above are going to have extra money to save from the tax cut. We should examine all aspects of saving, however. Most people think of saving as simply putting money in the savings and loan. What we are talking about in terms of saving now is not spending on consumption. This includes not only the voluntary things you do, but the things you have set up over a period of time, such as retirement plans and insurance contracts and so on. Many people below $15,000 income have savings in that form.

In addition, if those with incomes below $15,000 per year are basically dissaving, then the average rate of saving above that level has to be a lot higher than 5 percent to pull up the average. With the tax cut concentrated in the $20,000 to $30,000 range, you would expect some saving in that area.

Mr. MATSUI. I really find that hard to believe, because I know constituents in my district who are in the $30,000 range and they don't have much savings, and certainly they are not engaged in those kinds of investment practices that you are talking about.

Mr. WALKER. I suggest they are saving more than you think when you look at your life insurance and the savings banks and savings and loans.

Mr. MATSUI. I would like to suggest, Mr. Walker, that the comment that Mr. Anthony made—I think his statement is very much on point. The Business Roundtable, the U.S. Chamber, the National Association of Manufacturers, those are the interest groups that are going to have to go to the President before we adopt the budget and suggest to him that changes will have to be made because we will have a decifit of $150 billion.

He is not going to respond to the elderly. It is you that he is going to respond to and I hope you will take that back with you because I think that is going to be an important issue.

Mr. PICKLE. Mr. Moore?

Mr. MOORE. Mr. Walker, I want to compliment you on your comments, particularly concerning individual retirement accounts, and based on your testimony, I will agree with the introduction the chairman gave at the beginning of your testimony about you being a pretty smart fellow.

Let me throw out a few things. We had econometric studies done by Dr. Boskin of Stanford University and others that show that after the individual retirement account changes we made, it was believed that 75 percent of the people that would use the accounts had incomes of $35,000 a year or less.

That was designed to be the average workingman's tax shelter. In Canada, their savings rate went from the 5 percent range, when they adopted individual retirement accounts, to an 11 percent range. We are talking about 8½ percent, we are being conservative.

It depends on what kind of reaction we can elicit from the American people to save money.

Mr. Beck and Mr. Evans, I urge the two of you to take back to your organizations the request that each member company push to its employees the establishment of individual retirements accounts.

The IRS has ruled that any expenses you incur in helping employees set up individual retirement accounts is tax deductible.

They can set them up themselves or in pension plans. We believe the employees will find the money somewhere to begin to save regularly again so much a month to establish these individual retirement accounts.

That is the one thing that we as individual citizens can do to pull ourselves out of the recession.

As Dr. Walker said, for every additional 12 of disposable income which is saved, $20 billion of additional savings is realized. Thus, by increasing the savings rate by 3 percent, an additional $50 to $60 billion would not be out of the question.

You are talking about offsetting any increases in deficit spending which we are likewise going to try to get after.

The second point, I would be willing to look at a possible delay in some of these individual tax cuts, but I want to point out a recent article in the Wall Street Journal by Mr. McKinsey, where he studied what was going on in South Carolina.

We thought that the 25 percent tax cut would equal bracket creep. He writes, not so. He has done a study of every income group in South Carolina and concludes that real tax rate increases occur in spite of recently passed across-the-board tax rate reductions because people will be moving up through their Federal and State tax brackets faster than their Federal tax rates will be coming down.

The end result is that every one of the families will be left with less real spendable income in 1984 than they had last year. It boils down to any delay or repudiation of any part of an individual tax cut means that individual taxes will be higher.

They are going to be higher already, in the words of Mr. McKinsey. In addition to revenue raisers, I think we have to realize that anything we do with taxes won't be the solution to getting ourselves out of the high deficits for fiscal year 1983 and beyond.

Dr. Walker testified to that and the rest of you alluded to it. Something has to be done with spending. Something that intrigues me, what do you think of the idea that is floating through the Congress now that instead of trying to tackle the additional actual permanent cuts in spending which may be very difficult to accomplish this political year of reelection, that perhaps we can accomplish a greater dollar savings by freezing spending levels in 1983 at 1982 levels, including entitlement programs.

That would be a one-time type thing of a greater spending savings than the President is proposing, and give us some time to maybe come back in subsequent years like 1983 and 1984 and tackle the spending problems again.

What do you think about that solution?

Mr. BECK. I would like to respond to the first point if I might, that as you know, by and large ERISA was a disaster for small business. The IRA's are going to make it a lot easier for small business to reinstitute retirement plans that were canceled because of that.

It is going to take time. The other comment is that if the Congress will face up to the social security situation and get the social security retirement arrangement into order, I think you are going to generate a tremendous amount of confidence, because everybody

knows that this is a real problem and everybody says if they can't solve that problem, how can they solve anything else?

If the Congress is willing to face up to this and solve the problem, whether too much indexing, and get it on a sound fiscal basis, I think you are going to restore a lot of confidence in small business and in the general public.

Mr. PICKLE. We know that we have to make some changes in social security, but the difficulty is it doesn't have any direct relation to the budget. We have a trust fund and the indexing comes out of that, and there is a corollary because it is expense.

We have to make some of these changes. A lot of people are talking about all the great changes made. There is a theory that we ought to separate the trust fund, the social security trust fund from the budget so that you won't be mixing these apples and oranges.

You complain about the high deficit because of the social security problem. That is a separate item. I have worked with some of you, for instance Mr. Beach. The indexing is one aspect of the formula we have to change, but I don't think we ought to keep relating it directly as the main part of our overall budget problem, because I think that is a different approach.

Mr. BECK. I agree. I am just talking about perceptions on the marketplace.

Mr. PICKLE. Mr. Moore?

Mr. MOORE. I was asking for the comments of the panel and Mr. Beck was the first to comment on the idea of freezing Federal spending for 1983 at 1982 levels.

Mr. EVANS. Is this the idea of Senator Hollings?

Mr. MOORE. Similar to that, not necessarily encompassing each point.

Mr. EVANS. I am not sure. You mean just to stay everything for a time to look at the problem to debate it?

Mr. MOORE. I think it produces, according to his figures, a savings so that instead of the budget deficit we are talking, it would be down to about a $40 billion budget deficit.

We are talking about significant savings in outlays in 1983 by virtue of freezing spending levels in 1983 at the 1982 level, particularly entitlement programs.

Mr. EVANS. This would be true of the national defense budget as well?

Mr. MOORE. In all probability.

Mr. EVANS. I guess that would give people a little bit of trouble. If, indeed, we feel we have fallen behind on the defense side, I think business would say that we probably need to face that.

Whether we can wait 12 months just to look at it all is a good question. I really don't know. I don't think we have addressed that.

Mr. WALKER. I would like to comment on that and from the perspective of another hat I wear. I am Chairman of the Executive Committee of the Committee on the Present Danger. The Committee on the Present Danger was organized in 1976 because of the great concern about U.S. defense spending relative to the Soviet Union.

The committee met yesterday to review the defense figures. We had proposed a budget in 1980 that would close the window of vulnerability vis-a-vis the Soviet Union.

We went into every single aspect of defense spending on developing that budget. What the Reagan budget does, in effect, is to get on the trim line that we suggested in 1980, but a year later. But it is proposed by, I presume the Hollings proposal, freezing for 1 year outlays, or estimated defense to be $187.5 billion in 1982 to $221.1 billion in 1983.

That is a $34 billion increase, and I would shudder at that sort of additional 12-month postponement plus the fact that we are not talking about obligation authority here.

Congress has said these outlays are almost baked in a cake. If you freeze the outlays, you create all sorts of problems with having ongoing problems with weapons systems and what have you.

I side with Prof. Herbert Stein, who was here yesterday. I would like to see Congress approve every cent that the President has requested on national defense for fiscal year 1983.

Mr. PICKLE. The Chair recognizes Mr. Gephardt.

Mr. GEPHARDT. Thank you, Mr. Chairman, and thank you all for your constructive testimony. I think it has been very helpful.

I would like to first just make a comment. I am always fascinated with these questions of certainty for the business community and for everybody, for that matter, as to what economic policy will be.

I think it is a two-edged sword. If there is certainty that there is going to be high deficits, it is not the kind of certainty you want because that creates the kind of tentative reaction that we don't need, and so I think the substance is probably more important than the certainty, and if we could be certain about a stable fiscal policy that reduces the level of deficits, probably that is the kind of certainty we are looking for and not certainty about high deficits, but I think you have made some excellent suggestions for how to make some adjustments.

I said to David Stockman the other day that I thought he had the task of trying to blend a lot of different ideas in the administration, some of which were inconsistent, and come out with a policy, and that if we were to get these different ideas put together in a better blend, we had to make some adjustments in the program.

And I am glad to hear that you all have ideas for how some of those adjustments could be made.

I would like to ask some specific questions. Most of you have hit on entitlements and social security. Most of you have talked about the cost-of-living escalator. As you know, just changing the escalator in the years ahead if inflation is down is not going to make much difference in the cost of the program. So, I would like to know, do you have specific recommendations for what we could do to try to save money by doing something with the escalator, and if so, what are they? Let me just throw out two that I have heard.

One is that you try to make up for the over indexing of prices over wages over the last 4 or 5 years by arbitrarily reducing the CPI. One of you had an idea of above 2 percent, giving inflation above 2 percent for a period of years. I guess another way to do it is to give 90 percent or 80 percent of the CPI. Do any of you have any strong feelings about how that could be done?

Mr. BECK. As the late Julius Shiskin said many years ago, the CPI is not a good measure of inflation. He stated it very succinctly and positively. We are leaning too much on the CPI as a be-all and end-all of what is happening to the economy. It is a consumer price index, not an index of inflation. Joe Duncan's group recently as you recall put out a report—he is no longer the chief statistician of the United States, he has left the Government—but he put out a report on the revision of the CPI and the work the committee had done. I think we are making progress in that direction. I think we are, if I might paraphrase you, not talking about certainty, but consistency in terms of direction of movement.

I think we are moving consistently in this direction and making better sense out of some of our figures that we lean so heavily on to guide us. That is one of them. If we can continue to make progress, I think, and are consistent in our approach, it is what we are looking for. I do not think we can necessarily on the other hand say that the CPI is something that is going to guide our every action because there are other things we need to look at too. That is not an infallable indicator.

Mr. BEACH. I would add that the National Commission on Social Security Reform probably is going to have to look into a number of areas in this connection. I think business people are concerned, and not just with the current deficit in social security as it relates to our present budget problem. I think there is an even greater concern about the demands on the social security benefit programs which are going to escalate in the future.

There are great changes going on in the demographics of this country. Twenty years hence, we are going to have a much higher population over 65. We are going to have about 18 percent fewer people coming into the workforce at ages 18 to 24. Under these circumstances, we are going to have to look more to older workers to stay in the employment force. Our social security program, which was conceived in the 1930's, actually encourages people to retire early. The early retirement factor subsidizes early retirement. The incentives for staying in the work force after 65 are not adequate. They should be more generous and they should encourage people to stay in the work force longer. If 65 were an appropriate retirement age to focus benefits on back in the 1930's, I think as we approach the time when there are going to be more people over 65 and fewer younger active workers, serious consideration has to be given to very gradually moving up the retirement age.

Mr. GEPHARDT. I would ask two other quick questions of perhaps each of you if you could just comment very quickly. One, would any of you agree that we could cut back a bit on defense? Let me give you a specific proposal. Instead of the Hollings kind of freeze proposal, do you think within the budgetary constraints we are trying to live in and with the deficits we face that we could construct a path for defense that would be at the level of 3 or 4 or maybe even 5 percent real growth over the next 5 years each year, as opposed to the 7 that we are looking at? Do you think that would be a sensible thing to do to give a modest reduction to the growth of defense, taking into account the needs we have? And second, what would your opinions be on revenue raisers, tax increases? Mr. Walker gave his clear ideas on that. Do you believe that revenues

should be increased starting in the fiscal 1983 budget to give the deficit a different projection? And if so, do you believe that it should be done by excise taxes of the kind he talked about, or do you think it should be done through knocking out the third year tax cut as he also talked about?

Mr. WALKER. I want to respond to national defense right off. We are so far behind that I could not agree to any cut in the dollar amount of the President's proposal.

Mr. EVANS. I think the general business community, Mr. Gephardt, would say that in a national defense budget of $221 billion, probably something can be found that could be stretched out safely. It probably goes back to Mr. Blumenthal's thought about the equality of sacrifice. That is, if we are going to give up on one thing, we should give on everything. Therefore, I probably wouldn't be quite as strong as Mr. Walker. Although generally I think the business community feels that we must do something about our national defense posture, perhaps we could stretch it out a little longer. With respect to other actions, I think we would favor looking at excise taxes before the individual deferrals. We know that some of those you have thought about and have looked at. And some have been suggested. But perhaps that might be an area to look at again.

Mr. GEPHARDT. Does anybody else want to shoot at those?

Mr. BECK. It is hard to give a quick answer to such a question. But I would certainly disagree a little bit with Mr. Evans and certainly agree with Charlie Walker on this business of defense. We are so far behind, we have to catch up. I assure you I don't understand the DOD budget because it is so big and my calculator does not even have that many numbers on it.

Certainly I am not an expert. But I do feel we have been behind. I think most small businessmen feel we have been behind and need to catch up in defense. As far as the other question, I think it is a question of the lesser of two evils, what do you take? And sometimes you take neither. But certainly there are things that can be done. Last year we were very concerned at the outset about 10–5–3 and said so, and we were against it for two reasons. First, it didn't help small business particularly; but second, it would be such a tremendous drain on the Treasury. We were concerned then. I think there are things that can be done to improve the tax laws that were passed last year. I do not know what the roundtable feels about this. I am sure I will never be a member of the roundtable. But this business of tax leases bothers me. When I sit on the Federal Accounting Standards Advisory Committee and hear about the new standards to handle the leasing of taxes, that they are really not leases, they are really sale of assets and so on, I begin to wonder what has happened to accounting.

I am going to be awfully anxious to see just how much money it is going to cost the Treasury for companies to sell their tax benefits to other companies. How is this going to end up in loss to the Treasury in the end? It is too big for me to understand. Maybe there is an area here that needs some more looking at. I do not know. And I think there are probably lots of things, some of which have been recommended by the administration, are of some merit, and need to be looked at.

As Mr. Walker said, we are not talking about changing the thrust and direction of what has been accomplished last year, but rather in terms of polishing it, trying to improve it. I think there are things that can be done. But to make it a choice of this or that I think is a very unfair question.

Mr. GEPHARDT. I think my time is exhausted. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Archer will inquire.

Mr. ARCHER. Yes, I have appreciated your comments today. I think they are very, very constructive. I want to thank you for them. I have so many things I would like to ask you, and time is limited. I would like to start out by asking Mr. Beach, you made reference to loopholes in the tax law. I am curious as to what you consider a loophole, especially one that could and should be closed. And do you have any idea of how much additional revenue might be involved in the so-called loopholes, as you have put them?

Mr. BEACH. Well, in the first place, I am not an expert on taxation, so I am not in a position to recommend any specifics in that. I believe there has been much public discussion about possibilities of closing some loopholes. I would volunteer, for example, that the life insurance industry is concerned about the operation of the 1959 tax law which applies to it. The operation of the law in some respects has become very unfair. But there is also a provision in the law that has allowed some companies to take, in my view, unfair advantage of the law. I think that is an example of where we could, by negotiation with the Treasury, work out a proposition which was fair to the industry, and also fair to the Treasury, and perhaps give the Treasury $1 or $2 billion more of revenue.

Mr. ARCHER. So, you think we should take a very careful look at the Treasury's proposals in this area, which we of course do not have specifically yet, but which they generally have said they are going to get into?

Mr. BEACH. Yes, I do.

Mr. ARCHER. Thank you very much. I would like to ask you gentlemen how important you think the deficits and the projected deficits are on long-term expectations and long-term interest rates.

Mr. EVANS. I think we believe they are enormously important.

Mr. ARCHER. OK. That would be shared I assume by all of you. That is not what we are hearing from some economists today. You are basically in support of the thrust of what we have been doing here in the last year, but the thrust of that is producing some pretty massive deficits. And some people are saying, well, deficits really don't count. Don't pay any attention to that. But none of you would say that. Is that basically correct? All right. Thank you very much for that.

Mr. BECK. I am not sure I necessarily agree. Again, I would like to say that it isn't so much the size of the deficit, as if the public can see Congress making progress in the right direction. Trend. I think this does more to——

Mr. ARCHER. You know, let's face it. I am supportive of the President. I think he has done a fantastic job. I think he is one of the greatest leaders we have had in the White House in my lifetime.

But, I can't personally go with a $91.5 billion deficit. I think that would be grossly inconsistent for me and the position I have staked

out over the last 15 years. I assume that you agree that $91.5 billion is openers. Every time we passed a budget we have increased the deficit as we go along with supplementary things. Even if we assume the $91.5 billion is accurate, by the end of the year it is probably going to be well over $100 billion.

Mr. Beck, I have to assume you think that is too big a deficit.

Mr. BECK. Touché! I demur.

Mr. ARCHER. Ok. Let me ask you this, and I am concerned about this, gentlemen. And I want to elicit some response from you. I am a strong believer that we have to have a strong national defense. We are not going to have a strong foreign policy without a strong national defense. But where I would demure with respect to all of your comments, and where I hope you would also demure when this is pointed out to you, is that we should not be judging, and I hope you will agree with this, should not be judging our effort on national defense by the number of dollars that we throw at the problem. I think that is grossly inconsistent, because over the years we have said, hey, we are judging our success in social programs by the number of dollars we throw at the problem. And that is not the basis on which we ought to make that judgment. I think it is time for us to stand up and start talking about judging the end result at the end of the pipeline, number of tanks and effective tanks and planes and whatever other types of things we need, instead of just saying we have to throw these dollars out there because that somehow is magically going to determine what the extent of our defense capability.

Do you disagree with that, because each of you have said these dollars are sacrosanct. Apparently the image is being created for me that you think we should judge our effort in national defense on the number of dollars we put out there.

Mr. WALKER. I don't want to leave any impression at all. My basis for that statement, as I said, was a very thorough study which I will be happy to give to you or the committee on "Present Danger in 1980," which goes into chapter and verse in very great detail. It is not based upon dollars. It is based upon hard stuff in the defense area.

Mr. ARCHER. So, you basically don't feel there are any efficiencies that can be implemented in the Defense Department?

Mr. WALKER. No, I didn't say that. Efficiencies can be implemented anywhere.

Mr. ARCHER. Then these total dollars may not be a sacred figure?

Mr. EVANS. I don't believe they are sacred at all. I think the business community feels efficiencies can be found and we would encourage that very much. We would hope that is implied in what we are saying. We know that in our own businesses we are constantly trying to do things better. The efficiency part is incredibly important with us. With something as large as Mr. Blumenthal says he can't get his calculator around the numbers, you get the $220 billion, how in the world do we even understand it? Within that overall figure there should be ways, and there obviously must be ways to find some greater efficiency. We assume from what the President has said, and Mr. Weinberger has said, that they are devoted to finding ways to get those inefficiencies out.

Mr. ARCHER. I would like, I know I am out of time, I would like to get your comments on some of the specific proposals that have been made by the administration for tax changes which we will have to look at in this committee. They have not been fleshed out yet. We don't have the specifics and probably won't until next week.

But I hope we can get some input from you as to your feeling once we do see specifically what these proposals are.

Thank you very much.

Mr. BECK. We will be glad to submit them.

Chairman ROSTENKOWSKI. Mr. Vander Jagt will inquire.

Mr. VANDER JAGT. Thank you very much, Mr. Chairman. I don't have any questions, but I would like to thank the members of the panel for their statements. I apologize I did not hear the statements, but I have had the opportunity to read them. Your testimony has been helpful and instructive, and I would thank each of you.

Chairman ROSTENKOWSKI. Mr. Hance will inquire.

Mr. HANCE. Mr. Beach and Mr. Evans, the President, in his budget, requested a number of tax increases that are going to be fairly controversial in the business community. His proposals include repealing or altering the modified coinsurance arrangements for life insurance companies, capitalization of construction period interest and taxes for corporate taxpayers, repealing the completed contract method of accounting, withholding tax on interest and dividends and other proposals.

Are you endorsing these proposals, these tax increases?

Mr. BEACH. I would comment that we have no objection to looking into the problems of the modified coinsurance tax provisions. I commented on that in response to Mr. Archer's question.

Mr. HANCE. I am sorry, I didn't hear you. You all are endorsing the President's program as is?

Mr. BEACH. I think that is an area which should be looked into, and should result in the life insurance industry paying more taxes.

Mr. HANCE. So you would endorse the President's proposal as is without any changes?

Mr. BEACH. I endorse the recommendation to look into the modified coinsurance provisions which would raise more money. I am in agreement with the suggestion.

Mr. HANCE. But as far as the specific proposal, you would want to look at that a little closer?

Mr. BEACH. I am not aware that there is any specific proposal. I am merely suggesting that that matter be looked into.

Mr. HANCE. Mr. Evans?

Mr. EVANS. I would say that there is substantial concern about the proposal for the minimum tax, corporate minimum tax, in that it would appear to fall very unevenly, and would substantially lessen some of the benefits that were designed to take effect from last year's bill. Therefore, we would hope if the committee looks at that, they will look at it very, very carefully.

We assume you will, because it might have a very uneven application.

Mr. HANCE. Mr. Beck, you said one thing that I thought was very important: Anytime you have a chance in any of your businesses, if

you have a major change at Travelers, Union Pacific, or anyplace, you have adjustments after you make that major change.

I think we need to go through similar adjustments with the economy. Mr. Walker's suggestion to delay the tax cut is not, in my opinion, a major change. It is an adjustment. Most people would like to see interest rates down and would be willing to delay their final 10 percent tax cut by 6 months or a year if it meant improvement in the economy.

They would like to, you know, they would be willing to postpone it a few months. I appreciate your views on that.

Mr. Walker, you wanted to comment on the last question?

Mr. WALKER. I wanted to comment on what Treasury is evidently going to propose on the alternative minimum tax. This proposal is not a very good idea. It is counterproductive and does not have a basis in economic policy or tax policy. I think we will see that clearly when the details of the proposal are released. But let me make a broader comment about some discussion in the Senate and discussion elsewhere about—and Joe Pechman yesterday—a list of 40 items where he could raise revenue.

I don't think that you are going to solve the revenue problems in this budget with what I would call the Tax Reform Act of 1982, taking this little thing, and that little thing, and this thing, and so forth, adding up to a given figure. That is not going to do the job.

I think you have to deal in big chunks. I suggest in my statement that you look into areas where you can raise large amounts of revenue. You can raise $10 billion with a severance tax on natrual gas; $17½ billion on an oil import fee; upward of $20 to 30 billion on a delay in the last part of the tax cut.

So I am not enamored of the Joe Pechman approach to solving revenue problems. It has never worked.

Mr. HANCE. There are two items that I would certainly compliment you on, Mr. Walker. First, recommending a delay in the tax cut. I think it is something that should be considered and should be adopted.

The other is the oil import fee. I personally think the price of crude oil within the next year to 18 months is going to be $25 a barrel. It is dropping; it is dropping dramatically. This gives us an opportunity to raise some revenue in a certain area. And I think this would be a positive thing and a large sum.

The last thing I would say, and I think Mr. Anthony touched on it, is that there needs to be adjustments in the President's program. There can be some minor adjustments. The country then, I think, would get the perception we are headed the right way. Right now, the deficits, even if you take out the reality of the deficits, the perceptions of the deficits have just ruined the stock market.

And I think that unless we change that perception, the President's program is going to fail, because the President's program and the tax cut was not designed to work under 15 to 20 percent interest rates. You are not going to have a reindustrialization of this country with those types of interest rates. I think that if their assumptions had been right on interest rates at 11 percent, you would see a boom in the economy. But they were off on that. So I think we are going to have to make some adjustments. I hope the

business community will provide some of the leadership in helping do that.

Mr. EVANS. I think they will, Mr. Hance, providing we couple that with continued lower inflation rates, and if that perception comes through, the capital markets will respond.

If we look at a long-term lowering of the inflation rate permanently, just as Mr. Walker has said and others here have said, and I think I have said, interest rates will certainly come down.

Mr. HANCE. What would be the feeling of the four of you on the freezing of the spending rates, the Hollings approach, but if the freeze did not apply to defense?

Mr. WALKER. I would like to think about it. It sounds pretty interesting to me.

Mr. BECK. My first reaction is that it is the coward's way out.

Mr. HANCE. Freeze spending?

Mr. BECK. Yes, so we don't have to do anything now and won't dig into the problem. It is awfully hard to take an off-the-cuff look at that thing intelligently.

Mr. HANCE. Mr. Beach?

Mr. BEACH. I don't think I could endorse that without much further study to see what the real impact would be.

Mr. EVANS. It seems rather simplistic.

Mr. HANCE. Thank you very much, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Walker, would you recommend postponing any of the business cuts? You recommend raising taxes by an oil import fee and the deregulation of natural gas. What about accelerated depreciation? What do you think about delaying or eliminating certain aspects of that?

Mr. WALKER. I think that would be a serious mistake for a couple of reasons: First, I think it would play havoc with business planning. We are trying to struggle out of this decade of difficulty, to promote more capital formation. We have everything in place to make it attractive when interest rates come down and confidence returns. To rip those back, I think, would have a very counterproductive effect.

Second, when the 1981 cuts are fully effective, it is the case that even though some Members of Congress and the whole Senate were saying one-half of any tax cuts should go to business for capital formation, what we end up with is the lowest proportion of the cut going to business in modern times as Mr. Blumenthal suggested.

Chairman ROSTENKOWSKI. Are you saying that we should not raise business taxes? That we should just raise individual taxes?

Mr. WALKER. I am not saying you should cut any of them right now.

Chairman ROSTENKOWSKI. You are talking about the third year cut for individuals, aren't you?

Mr. WALKER. I am talking about a postponement possibly there of 6, 9 or 12 months. But as far as business taxes are concerned, they will be only 22 percent of the total cuts at that time, and I think it would be totally counterproductive to cut that back at all. The administration's proposal's cut business tax reductions back significantly. That is not to be desired.

Chairman ROSTENKOWSKI. Beryl Anthony must go back to Arkansas, and try to get the people back there to reelect him. What is he

to say to those people? Is he to say: "I am going to raise your taxes, but not business taxes"?

Mr. WALKER. What he would say to them?

Chairman ROSTENKOWSKI. He will not say that to many.

Mr. WALKER. If I were his campaign adviser, what I would suggest?

Chairman ROSTENKOWSKI. Keep that quiet. Don't say anything about it.

Mr. WALKER. Come out against him is what you are trying to say.

Chairman ROSTENKOWSKI. What do you think his opponent would say?

Mr. WALKER. I don't know what his opponent is going to say. I can tell you the kind of thing I would say. I don't know how it would sell in Arkansas, but the point to me is what we are seeing right now in the press, the Washington Post, and unfortunately with the administration proposing a minimum corporate income tax, I thought we had finally succeeded in convincing the people of the United States, and I believe Ronald Reagan was the first to enunciate this in the 1950's that there is no way in the world you can make a corporation pay taxes. It is just not possible.

Those taxes are either passed on to the consumers of the corporate products or backward, to workers or stockholders. When passed forward to consumers, the tax is regressive, because people who have low income spend more money on corporate products than people on high incomes. Most people I talk to say, "I know when I buy a car, the tax is passed on to me." If the tax is passed back to the stockholders, it hurts the capital formation we need so badly.

Why we let the press continue to bamboozle us that you can tax a corporation without hitting people is a mystery to me.

Chairman ROSTENKOWSKI. You referred to having corporate taxes behind us—that the administration is no longer speaking with one voice. We hear several voices about how taxes should be raised or how the budget should be balanced.

We hear the Baker voice. We hear the Dole voice. We hear the Reagan voice. Well, the Regan and Reagan voices are still in harmony.

Mr. CONABLE. What we really want is a Rostenkowski voice.

Chairman ROSTENKOWSKI. Something might surface if we work in a cooperative atmosphere as we did last year.

Mr. Beck, are you hiring these days? What are your hiring plans?

Mr. BECK. Our normal complement is 35 people. We have nine on layoff at the moment. They were laid off late last spring, and they have run out of their unemployment compensation term. We are in close touch with all of them, and we are anxious for business to pick up so we can get them back.

Have I answered your question?

Chairman ROSTENKOWSKI. Yes.

Do the leasing provisions provide any great assistance to the small business community?

Mr. BECK. To our customers, probably they do. To us, they don't.

Chairman ROSTENKOWSKI. So the small business community is not benefiting by safe harbor leasing.

Mr. BECK. I can't say that. I would say they are certainly not benefiting directly. Certainly to the extent that big business is. I think this is obvious, and it can be shown. Small business is primarily labor-intensive, as we know.

Chairman ROSTENKOWSKI. Mr. Anthony will inquire.

Mr. ANTHONY. Mr. Chairman, I guess I have so many questions that were left unanswered, but this panel has probably made some of the better suggestions that I have heard from any of the witnesses, although some of them, again, are controversial. I just want to lay out a scenario, and see if you think there is any contradiction to the extent it may cause problems as far as having any upturn in the economy. Right now, in the budget the administration is projecting a falling interest rate, a large budget deficit, but increased savings.

It appears to me there is a built-in contradiction to that assumption; that, as interest rates fall, there is less incentive to save, more incentive to spend, and your savings pool is reduced. And if you do have large Federal deficits, then under those scenarios, then you do start running into the clash that we are all fearful of between the Federal Government financing its debt and rolling over its debt, and the private independent industry beginning to see the business outlook picking up and starting to place new orders for plant and equipment.

Does that bother you? Or is that not a contradiction? Am I just looking at it wrong?

Mr. WALKER. Conceptually, Mr. Anthony, I don't think it is a contradiction, if the inflation rate continues to go down. The inflation rate is a very powerful factor on decisions to save. Also, taxes are being cut; there is more disposable income to be saved. Taxes are cut in terms of marginal rates, which significantly increases the rate of return on each individual dollar saved.

All of that sort of thing combined, you could very easily have that sort of scenario. I hasten to add, it won't necessarily work out if you have these continued market expectations that we have had. Conceptually, no; to me, it is not contradictory.

Mr. BEACH. I would merely add that if you have the lowered expectations of inflation, individuals will not only save, but they will also be willing to invest long-term. That is what industry really needs.

Mr. EVANS. And I think once we give the IRA's the chance to really take hold, we may see some very sharp savings pick up.

Mr. ANTHONY. Since you mentioned the IRA, I would just like to lay this out on the table, Mr. Chairman. I had a 75-year-old man call me on my last district work break. He said, "Mr. Anthony, I have worked all my life. I have saved. And I have to pay tax on the income that I earn from my savings at whatever tax bracket I am in." I think that he was in the 17-percent income tax bracket.

He said, "Why are you punishing me because I have been good and diligent all these years, yet now you are providing these incentives for people to save in 1982?"

I must admit, I didn't have an answer for him.

But there was a comment earlier about making sure what we do is fair and equitable. If we don't do that, then we do have the political problems of convincing the public to go along with their political leaders and decisions.

Mr. CONABLE. Did you tell him about the extra exemptions for the elderly and tax-exempt revenue from social security and a few of the other things that have benefited him that don't benefit other people?

Mr. ANTHONY. Well, I must admit, I didn't sit down and go through his entire financial status and situation, and try to explain it all in detail. Maybe it was a failure on my part, because he was just pointing out one contradiction; at least he felt like he was treated in one area of savings versus how another citizen is treated in the area of saving. That is the reason I just laid it out, to see whether or not we did overlook somebody or whether or not there is a logical explanation for it.

I appreciate Mr. Conable bringing out the other side. I do have his name and address. I will write him and mention some of those things to him.

Mr. BECK. I think you could do something for him, too, in the social security area, if every dollar that you wanted to earn for the good of the economy, he didn't lose 50 cents of it.

Mr. ANTHONY. I yield back the balance of my time, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Conable will inquire.

Mr. CONABLE. I don't have any questions, Mr. Chairman. I regret having arrived late and not having heard your testimony in chief. I have enjoyed the exchanges we have had since I have been here and I appreciate your advice.

I must say that we are in for a rather difficult year and that we are going to need all the help we can get. I am hopeful that you gentlemen will continue your public-spirited inputs as we go through this year.

Chairman ROSTENKOWSKI. Gentlemen, thank you for participating in this hearing. It has been very generous of you. We have certainly been enlightened.

Thank you.

The committee will stand adjourned until 9:30 Monday morning, when Mr. Stockman will testify.

[Whereupon, at 12:30 p.m., the committee was adjourned, to reconvene at 9:30 a.m., Monday, February 22, 1982.]

ADMINISTRATION'S FISCAL YEAR 1983 ECONOMIC PROGRAM

MONDAY, FEBRUARY 22, 1982

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The committee met at 9:30 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman ROSTENKOWSKI. The committee will come to order.

Good morning, Mr. Stockman. Many of us on this committee have looked forward for some time to having you back with us. You and I know that many questions will be raised about 1981. Knowing you as I do, I am sure you will be able to handle them with aplomb.

My concern, however, is not for the past, but for the present and what we expect to see on the horizon.

I will not spend my time this morning talking to you about the projected $90 billion deficits. You know as well as I that such deficits are totally unacceptable.

I would like to spend my time, and I hope we can all spend our time, talking not about how we got here, but where we are going and how to get from here to there.

I hope your remarks will focus on areas where the administration is flexible and what we can do together to solve the significant economic problems that plague our country.

The year 1982 is an even-numbered year, Mr. Stockman. I am sure you are aware of what happens in even-numbered years. When it comes to the economy I do not believe that we can afford to be political.

In your remarks, I hope you can minimize the issue of confrontation between Congress and the administration. Please focus instead on areas where we can and should work together.

With that Mr. Stockman, if you are ready to proceed with your testimony, the committee is ready to receive it.

STATEMENT OF HON. DAVID A. STOCKMAN, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. STOCKMAN. Thank you, Mr. Chairman.

I am delighted to be before your committee today and especially to hear your opening remarks. I hope we can spend most of our time discussing how we get from where we are now to where we should be in the future. I believe, however, that it also would be

important for the committee and for you to have our perspective as to why we are suddenly confronted with a budget that looks far different, with deficit numbers that are far higher than anything we have ever seen before, and with the clarification as to what forces and factors caused those.

With your indulgence, I would like to take a few minutes to highlight my testimony and then we can proceed to the discussion of current options and future direction with that background in mind.

Mr. Chairman, I think it would be fair to say this budget that has been presented to the Congress for fiscal year 1983 is the most difficult budget ever presented by an administration because it arises from the most unique and challenging fiscal and economic circumstances that we have ever faced.

All at once we are attempting to move from a clearly overtaxed economy that was inhibiting growth to a lower taxed economy that will promote growth; from an economy in which the inflation rate was rising rapidly to an economy in which the inflation rate is thankfully rapidly falling.

We are moving from a period in which our national defense was grossly and inadequately funded to a period in which, hopefully, we will rebuild our military capability and capacity to support our foreign policy objectives.

We are moving from a period in which the interest rate ran behind or near the inflation rate to an unusual period in which there are large and huge premiums above the inflation rate in the interest rate that we will pay on the Federal debt.

All of these factors are driving through the budget and contributing to the imbalance that we are faced with and that must be urgently corrected.

We are also moving from a period in which overall Federal spending was out of control—increasing to a rate of 17.4 percent in 1980, to a period in which firm discipline is being imposed on the overall growth of Federal spending with a target increase of 4.5 percent in 1983. This is imposing enormous pressure on domestic program funding; the levels we would like to provide versus the levels that we can afford.

All of these factors together make for unprecedented circumstances in making a budget for this country. They create enormous cross pressures and challenges that force us to depart from business as usual and they present to you and the committee and the Congress uncommonly difficult choices as you attempt to grapple with this fiscal year 1983 budget just as we did over the last 3 months.

As we look at the fiscal year 1983 budget and the current fiscal and economic circumstances, I think four things stand out readily:

First, and this is the problem that we face, Mr. Chairman, and that you mentioned in your opening remarks: In the absence of a comprehensive budget savings effort, the Nation faces continuous deficits of unprecedented size on a current services basis; that is, with no policy action as a result of sitting on our hands during this session. The projected current services deficits range, depending on whether you use optimistic, moderate, or pessimistic economic assumptions, anywhere from $130 to $160 billion in 1983, rising to

the $133 to $200 billion range in 1984 and to $120 to better than $200 in 1985. That is the dimension, the raw dimension of the problem that we face. That will be the result unless somehow this administration and this Congress working together can devise plans and budget savings measures designed to reduce substantially and dramatically those built-in deficits that we confront under current law and current policy and present economic circumstances.

Second, the President's comprehensive budget savings plan is designed to reduce dramatically these prospective deficits and insure that they decline steadily from the fiscal year 1982 recession peak.

The President's plan proposes $56 billion worth of deficit reduction measures in 1983. If implemented this year by the Congress and the administration working together, these savings will rise to nearly $100 billion by 1985, for a total of $239 billion in deficit savings over the 3-year horizon that we will be addressing in the budget resolution later this year.

If these plans or similar plans can be implemented, we will reduce these prospective deficits that I have just described on a current service basis by more than 50 percent. We will lower the 1983 deficit below the recession peak of 1982, and we will start a trend that moves the deficit steadily down.

These deficits are large, too large, but they are manageable and there are future opportunities next year and the year after to reduce them further. Before we can walk, we have to crawl. To achieve even the deficit targets after policy measures that we have proposed in our budget will be most difficult and will take unusual and uncommon coordination and goodwill and good faith on the part of all parties concerned in both the executive and legislative branches.

The third thing that stands out, Mr. Chairman, the remaining deficits after all of these policy savings are implemented, are largely due to changes in the economic outlook since last February. These changes include the recession, higher interest rates, and a more rapid than anticipated slowdown of inflation.

All of those forces of economic transition led in the budget to greater imbalance and were uniformly underestimated by all budget and economic forecasts of 1 year ago.

Budget projections based on the economic forecasts issued last year by the administration, by CBO, by DRI and outside forecasters, and in the Carter January budget would underestimate current deficits by the following ranges: From $31 to $57 billion for 1982; from $40 to nearly $90 billion for 1983; and from $30 to nearly $90 billion for 1984. Those numbers express the impact on the budget that has occurred in an adverse direction as a result of the change in economic circumstances and the economic outlook since last year.

The fourth thing that stands out is that the current service deficit we have addressed and have attempted to quantify here that requires urgent action this year by the Congress is roughly of the same magnitude, whether calculated from the actual administration tax and budget program enacted by the Congress last year or from the alternative fiscal program embodied in the Ways and Means tax bill and the House Budget Committee first budget resolution.

Therefore, my point this morning, Mr. Chairman, is that our present fiscal predicament is a common consequence of current and future economic forces impacting the budget, not the result of fiscal options chosen or rejected last year.

Those options were sound. Those options were necessary to achieve basic objectives that we have for the future of this country. We should not reopen that debate. We should recognize that our current larger than expected challenge results from changes in the economic response, to pressures in our economy, and to changes in policy. We should accept that as a given fact and move forward with new policy actions in 1982 and 1983 designed to reduce those deficits to the minimum magnitude possible given our other objectives.

As I indicate on page 3 of my prepared testimony, the current services deficit with the actual program adopted last year is $146 billion in 1983 and $165 billion in 1984. Those numbers do not differ substantially from what would occur had the congressional alternative program been adopted.

Mr. Chairman, the appropriate starting point as we consider our budget dilemma in fiscal year 1983 is the range of budgetary projections of current services.

As I have indicated, these projections indicate serious danger to economic recovery, to the stability of financial markets and interest rates, and to the economic well-being of every American if they are not addressed and remedied forcefully and in a comprehensive way.

My prepared testimony shows a range of current services deficit paths based on the administration economic forecast and two alternative forecasts—one that has a higher rate of real growth and lower inflation, another that has a lower rate of real growth and higher inflation.

My point in presenting this table is to demonstrate that the threat to fiscal balance and economic recovery transcends the plausible range of economic assumptions that we could choose for this year's budget and fiscal policy and cannot be mitigated without comprehensive policy action.

These deficits cannot be solved by assuming a better forecast. These deficits will only become worse by assuming a less optimistic forecast, but the main thing is, they are not driven by the forecast; they are driven by the current circumstances, the economy, and there is urgent need to move forward.

Mr. Chairman, the second point I would make this morning is to review just very briefly the major factors that have changed in the economic outlook and the magnitude of their impact on the deficit and budget projections for the next several years.

As I have indicated, last year, as we sat down to write a budget and to make fiscal policy on both the tax and spending side, we did not see the present recession. At least in terms of its duration and severity.

We did not see the rapidly falling rate of inflation that we have experienced last year and especially in the past 6 months.

We did not see the greater than expected tightening of monetary policy in mid-1981 and the prospects that have caused sharply reduced nominal GNP levels during the recovery period of 1983 and

the out years. We did not foresee—by we, I mean all forecasters and all budget makers involved—the emergence of unprecedented premiums above the inflation trend in nearly all interest rates and the prospect that these premiums will diminish only slowly over time as policy credibility is re-established.

All of these factors represent economic adjustment forces operating as the economy moves from a condition of excessive money and credit growth, uncontrolled Federal spending, rising inflation, and stagnating real growth, to lower inflation, revived real growth, and monetary, financial, and interest rate equilibrium.

All economic forecasts used last year for budget projections underestimated the severity of these economic adjustments and their profound large and adverse consequences for the budgetary outlook.

The table we have provided in my prepared testimony this morning, Mr. Chairman, compares the administration deficit projection including all proposed budget savings measures with re-estimates of that same budget and that same policy based on early 1981 economic assumptions from a variety of sources.

In every case the deficit projections are dramatically lower because the economic adjustment forces described above were not anticipated.

On an average basis, the changed economic outlook has increased the projected deficits—taking all the variety of forecasts that were available—by $42 billion in 1982, by nearly $60 billion in 1983, and by nearly equal amounts in the out years.

If we simply focus on 1983, we can see very clearly what these economic forces have done to worsen the deficit outlook. We are projecting, as you know, a $92 billion deficit for fiscal year 1983. Had the economic assumptions been from any of the four forecasts used early last year, those deficits would be dramatically lower: $32 billion in the case of the January budget of the previous administration, $2 billion in the case of our original forecast, $46 billion in the case of the DRI forecast, and $52 billion in the case of the CBO forecast.

Let me go through very quickly the major changes in the current and prospective economic environment that have contributed to those dramatic changes and increases in the expected deficit level.

All major forecasts last year assumed that after a few sluggish quarters in calendar year, 1981, economic expansion would resume strongly in the fall and on into 1982.

As a consequence, the 1982 nominal GNP growth rate was overestimated by 50 to 65 percent, and when this is combined with higher unemployment, fiscal year 1982 budget receipts and unemployment related outlays were off by large magnitudes.

As you can see on the table on page 10, receipts by everyone were overestimated by $36 to $45—excuse me, by $30 to $38 billion for 1982 and outlays were underestimated by anywhere from $6 to $8 billion, for a total underestimate of the deficit for 1982 ranging between $36 and $45 billion.

That is primarily the recession impact of the lower nominal GNP.

The second factor that is severely affecting the deficit projections for the out years—the 1983 budget we are dealing with now and

1984 and 1985, which will be in the resolution—is that the path of nominal GNP—income of the business and household sector of our economy—will be decidedly lower than we expected only a year ago, as a result of the recession and of the falling rate of inflation.

If you look at the chart that we have provided in my testimony, I think it is fairly clear that as a result of this falling rate of inflation there has been a dramatic change in the outlook for receipts.

The reason for that, Mr. Chairman, is that as we pull out of this recession, there will be a lid on the growth of nominal GNP and, therefore, budget receipts, if we keep the anti-inflation monetary policy in place.

That contrasts very markedly with the experience we have had in previous recession/recovery cycles and I cite in my testimony the 1975–78 cycle, where we made great headway during that recession in reducing the rate of inflation down to about 4 or 5 percent. Then during the next 3 years we lost it all as monetary policy turned very expansionary, the economy was gummed up with rapidly rising increases in the money supply, and inflation took off once again.

Specifically, money grew at 5 percent during the recession year of 1975, increased to over 6 percent by 1976, and was up to 8.2 percent by 1977.

This permitted an equally rapid recovery of nominal GNP growth from 8 percent in 1975 to well over 12 percent by 1978.

The consequence was rising prices and rapid inflation—fueled growth of budget receipts, thereby reducing and minimizing the apparent deficits.

By contrast, during 1982 to 1985, just the opposite pattern will occur if anti-inflation monetary policy remains on track.

After the anticipated recovery of nominal GNP in 1983, the nominal GNP growth rate will fall steadily—rather than rise as it has in past recovery periods—as inflation is squeezed out of the economy and the lid on money growth is maintained.

This lid on money growth, inflation, and nominal GNP, means that there will be no inflation-fueled growth of budget receipts as occurred during previous business cycles.

We have provided a schematic illustration of this on page 16 of my testimony, which I think clearly indicates the magnitude of the budget problem that we will face as we move into recovery and toward a steady reduction of the inflation rate.

This anti-inflation lid on money growth, nominal GNP, and budget receipts was not accurately reflected in any of the early 1981 forecasts, including that of the administration.

In combination with the failure to predict the much lower 1982 recession GNP levels, this means that the 1983 to 1985 nominal GNP, which determines the level of receipts or tax revenues that we achieve, were drastically overestimated by all forecasts.

On page 18 of my testimony I give some indication of that.

You can see that the numbers, both for nominal GNP and budgetary receipts, are huge. If you take our forecasts, we were off by $133 billion in 1982 on nominal GNP, rising to $242 billion by 1985.

If you take the CBO forecast of nominal GNP for the same period, they were off by $116 billion in 1982, raising to $192 billion by 1985.

As the bottom of that chart shows, that has dramatic effects on the prospect for budget receipts. We over-estimated receipts by $31 billion in 1982, rising to $60 billion by 1985; CBO overestimated receipts by $30 billion in 1982, rising to $71 billion in 1985.

This development is positive for the economy, but it causes or imposes an unintended and severe impact on the budget as we move through the disinflation process in the economy.

A third change that was not fully anticipated by us or any other forecasters last year as we attempted to project budgets, was that there has been a major change in the relationship of the interest rate and the inflation rate that will take some period of time to reduce. Throughout the 1970's, the rise of interest rate just paralleled the rise of inflation and in many years lagged behind it.

In the T-bill market, on which we finance the Federal debt, the average real interest rate—that is, the nominal rate minus inflation—was actually negative, meaning that for a good part of the decade the Federal debt was financed at a negative rate of return. As the inflation and financial disorder worsened in 1979–80, the financial markets adjusted, long-term lending dried up, and huge premiums above the inflation rate appeared in securities throughout the maturity spectrum. These premiums reached unprecedented size throughout 1981.

The table we have provided on page 21, I think, demonstrates this rather dramatically. Throughout the period of the 1970's, you can see the T-bill rate, interest rate, and the inflation rate tracking very closely.

Then during 1981 a premium of 4- to 6-percent above the inflation rate opened up and, of course, this has had major and substantial impacts on the costs of servicing the debt and on projections for the future.

It now appears, Mr. Chairman, that these interest rate premiums will remain sticky during the transition to lower inflation. While progress in reducing interest rates can be expected, it will take time to restore long-term financial confidence, refinance short-term business and household liabiliites, and to bring credit demands—including government credit demands and availability—into balance.

As a consequence, the administration's current forecasts assume substantially larger interest rate premiums over the next several years than did almost all forecasters of 1 year ago.

Rather than the traditional 1- to 2-percent spread, we are projecting 4 percent or a greater spread of premium throughout the period ending in 1984.

Again, this will have major impacts on the budget, increasing interest rate-related outlays by $8 billion in 1982 and by more than $54 billion over the 1983–85 budget period that we will be addressing.

While other forecasters in 1981 assumed a somewhat higher nominal rate, they also projected excessive levels of inflation in nominal GNP. When all forecast factors are reduced to the bottom line, added deficit and increased future year debt, the conclusion is the same.

Debt service outlays due to larger deficits will be substantially higher, even if the administration's complete budget savings program is adopted.

On page 25 we again estimate the increase in debt service over the 3 years 1983 to 1985 that will result from the combined impact of these forecast underestimates last year. In the case of our own estimates, $53 billion will be added to debt service outlays; in the case of CBO, $24 billion over that 3-year period, and in the case of the other forecasts, somewhere in between.

Mr. Chairman, what all of this amounts to is the following: This makes clear that the original administration economic and budget forecasts along with all others issued early last year on which fiscal policy was based, did not anticipate the gale-like forces that a slowdown in money, credit, national income growth, and the resulting financial and economic adjustments, would unleash on the budget.

It is now clear that the process of disinflation works powerfully against budgetary equilibrium, at least for an interim period of time and that the challenges of fiscal policy management have become decidedly more intense than anyone imagined just a few months ago.

It is this disinflation process that is largely responsible for the dramatic deterioration of the budget outlook since last year.

The more abrupt than expected slowdown in money growth between 1980 and 1981 from 7.2 percent to 4.9 percent in the context of accumulated financial weakness and depressed long-term capital markets tripped the economy into a temporary recession and correction of underlying and financial economic imbalances.

The resulting higher interest rates and borrowing have added nearly $17 billion to the deficit for 1982. As the recovery gathers force through 1983 and 1984, the anti-inflation monetary policy will impose a lid on the recovery of nominal GNP and budgetary receipts.

Thus, the budget receipts projection has substantially been reduced since last year. Receipts will be $53 billion lower in 1983, and $170 billion lower over the next 3 years.

The $249 billion in indexed programs in the fiscal year 1983 budget will respond to lower inflation, but only with a lag due to the base period adjustment mechanism.

This difference between contemporaneous and lagged adjustment that we have in the law today will add $5 billion in outlays in 1983 and $8 billion in 1985. This is a way of saying that as the receipts fall immediately in response to lower inflation, outlays take 2 or 3 years to catch up, widening the budget imbalance during the interim.

The recession induced rise of unemployment to the 9 percent range will take longer to work down and, as a result, unemployment-related outlays will be $14 billion higher over the next several years.

Restoration of financial market confidence and stabilty will take more time than previously anticipated, resulting in higher interest rate premiums, as I have indicated, than previously forecast.

We are now forecasting an interest rate path for the T-bill that will average 260 basis points higher than last year. This will add $15 billion in outlays in 1983 and $54 billion over the 3-year period.

If you take all of these factors together, the higher unemployment-related outlays, the lower receipts, the higher interest rate-related outlays, they will add $31 billion to the debt financing costs of the Federal Government in 1983 and $107 billion over the next 3 years.

The huge differences in budget and deficit estimates shown in the table on page 31 of my testimony, I believe, are therefore due to the change in economic outlook since last March. As I have indicated by way of comparison with other forecasts—CBO, DRI, the January Carter budget and so forth—those changes are not unique to our forecasts, but were a common problem confronted by all.

Mr. Chairman, I want to indicate one more derivative point from this that I think is crucial to understand as we then begin to deliberate this year as to how those unintended and unexpected large deficits can be reduced.

My point is that if progress is not made, if substantial reductions are not achieved from the huge built-in deficits that we face today due to conditions in the economy, then we face a potential explosion, literally an explosion, of debt service costs in the future as these higher deficits wind into the debt, put upward pressure on interest rates, and increase dramatically the total debt service or debt interest outlays of the Federal Government.

The increased interest rates and debt financing requirements for fiscal year 1983 to 1985 add $94 billion to the projection of net interest outlays compared to just last February.

If no action is taken on the fiscal year 1983 budget savings program that the administration has presented, then over the next 3 years another $33 billion will be added to net interest outlays simply to finance the higher deficits that will result. If in the face of no action on the program this year economic performance weakens under the burden of these debt financing requirements to a lower growth, higher inflation path, then another $37 billion in added debt service outlays would be added over the next 3 years.

If you look at the chart that we have provided on page 33 of my testimony, I think you can see the dramatic escalation in net interest or net debt service costs and the potential for further escalation in the future if policy action is not taken this year to reduce the built-in deficit and if the economy weakens as a result of these actions not being taken.

The other point that I want to stress in just a little bit more detail here for a moment, Mr. chairman, is the point I referred to earlier; namely, that we are in the same boat and face a common problem that does not result from actions or policy options rejected or accepted last year.

The fiscal policy alternatives considered by Congress last year would have had a similar impact on the current budget outlook. Similar large current services deficits result from either the administration program as adopted and by the House Ways and Means and Budget Committee tax and spending alternatives that were not adopted.

The table on page 37 provides a comparison of current services projections of major spending and tax policy options considered by the Congress and the administration's program, as finally enacted.

Both projections are based on the current administration forecast. Had the first budget resolution spending policy recommendations proposed by the House Budget Committee been adopted, aggregate current services outlay projections would have been similar to those that result from the policies actually implemented except for a modest reallocation of about $7 billion from the defense to the nondefense outlay part of the budget for those years.

Similarly, had the Ways and Means Committee tax bill been adopted, the third year of the individual rate cut would not be triggered in January 1984 as provided by the bill, because obviously the $23 billion deficit and interest rate target would not have been achieved.

Nevertheless, due to other provisions of the Ways and Means alternative, the fiscal years 1982–84 revenue costs would have been similar, $269 billion over the 3 years for ERDA, $253 billion over the 3 years for the Ways and Means alternate minus the third year rate cut.

As a consequence, current services deficit projections for 1982 to 1984 are nearly identical. This is shown in the table on page 37. I again go over these numbers simply to indicate that the problem we face would be here whether we took one course of action or another last year.

Mr. Chairman, these views that I presented in my testimony are not designed to solve the problem this year, obviously. They are designed to explain the context and provide some sense of the foundation as to what economic forces have created, and the current challenges, dilemmas, and difficulties that we face.

The President has proposed what I believe is a comprehensive, balanced, and bold program to reduce those deficits that we face under current economic conditions. This committee and this Congress may have other ideas as to how $239 billion in budgetary savings or revenue increases can be achieved over the next 3 years. We certainly invite and welcome those ideas and I think on the part of the administration our only concern, our only caveat would be that as we seek to grapple with these transition problems, that we not jettison, that we not undo, that we not retreat in some fundamental way on achieving those objectives and those policy directions on taxes, on national defense, and on the growth of the budget that Congress put in place last year.

Mr. Chairman, those are my opening remarks. I would be very happy at this point to take your questions and questions from other members of the committee.

[The prepared statement follows:]

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

PRESENTATION OF THE HONORABLE DAVID A. STOCKMAN
DIRECTOR OF THE OFFICE OF MANAGEMENT AND BUDGET
BEFORE THE
HOUSE WAYS AND MEANS COMMITTEE

FEBRUARY 22, 1982

I. OVERVIEW OF CURRENT FISCAL CONDITIONS AND ISSUES

- IN THE ABSENCE OF A COMPREHENSIVE BUDGET SAVINGS EFFORT, THE NATION FACES CONTINUOUS DEFICITS OF UNPRECEDENTED SIZE. ON A CURRENT SERVICES BASIS (NO POLICY ACTION) THE PROJECTED DEFICITS RANGE AS FOLLOWS, DEPENDING UPON WHETHER OPTIMISTIC, MODERATE OR PESSIMISTIC ECONOMIC ASSUMPTIONS ARE USED: (BILLIONS)

FY 83	FY 84	FY 85
$129 - 162	$133 - 197	$120 - 216

- THE PRESIDENT'S COMPREHENSIVE BUDGET SAVINGS PLAN IS DESIGNED TO REDUCE DRAMATICALLY THESE PROSPECTIVE DEFICITS AND ENSURE THAT THEY DECLINE STEADILY FROM THE FY 82 RECESSION PEAK.

	83	84	85
ADMINISTRATION BUDGET SAVINGS PLAN.....	-56	-84	-99
REMAINING DEFICIT.....	92	83	72

- THE REMAINING DEFICITS ARE DUE TO CHANGES IN THE ECONOMIC OUTLOOK SINCE LAST FEBRUARY, INCLUDING RECESSION, HIGHER INTEREST RATES AND A MORE RAPID THAN ANTICIPATED SLOW-DOWN OF INFLATION. ALL OF THESE FORCES OF ECONOMIC TRANSITION HAVE DRIVEN THE BUDGET TOWARD GREATER IMBALANCE -- AND WERE UNIFORMLY UNDERESTIMATED BY ALL BUDGET AND ECONOMIC FORECASTS OF ONE YEAR AGO. BUDGET PROJECTIONS BASED ON ECONOMIC FORECASTS ISSUED LAST YEAR BY THE REAGAN ADMINISTRATION, CBO, DRI AND THE CARTER - JANUARY BUDGET WOULD UNDERESTIMATE CURRENT DEFICITS BY THE FOLLOWING RANGES: (BILLIONS)

1982	1983	1984
31 - 57	40 - 89	29 - 91

- THE CURRENT SERVICES DEFICIT REQUIRING URGENT ACTION THIS YEAR IS OF ROUGHLY THE SAME MAGNITUDE WHETHER CALCULATED FROM THE ACTUAL ADMINISTRATION TAX AND BUDGET PROGRAM ENACTED BY CONGRESS LAST YEAR, OR FROM THE ALTERNATIVE FISCAL PROGRAM EMBODIED IN THE WAYS AND MEANS TAX BILL AND THE HBC FIRST BUDGET RESOLUTION. OUR PRESENT FISCAL PREDICAMENT IS A COMMON CONSEQUENCE OF CURRENT AND FUTURE ECONOMIC FORCES IMPACTING THE BUDGET -- NOT FISCAL POLICY OPTIONS CHOSEN OR REJECTED LAST YEAR.

	83	84
CURRENT SERVICES DEFICIT WITH ADMINSTRATION PROGRAM AS ENACTED.....	-146	-165
CURRENT SERVICES DEFICIT WITH 1981 CONGRESSIONAL ALTERNATIVES*.....	-150	-149

* ALTERNATIVE TAX POLICY BASED ON H.R. 4242 AS REPORTED FROM THE WAYS AND MEANS COMMITTEE ON JULY 24, 1981, AND ALTERNATIVE SPENDING POLICY BASED ON H. CON RES. 115 REPORTED FROM BUDGET COMMITTEE ON APRIL 16, 1981.

II. CURRENT SERVICES DEFICIT ESTIMATE: DIMENSIONS OF THE FISCAL PROBLEM

- THE APPROPRIATE STARTING POINT IS THE RANGE OF BUDGETARY PROJECTIONS AT CURRENT SERVICES. THIS REPRESENTS WHAT WOULD HAPPEN IF WE SIT ON OUR HANDS, PERMIT THE BUDGET PROCESS TO POLARIZE OR PARALYZE, AND ALLOW THE BUDGET MOMENTUM TO RUN FORWARD ON AUTOMATIC PILOT.

- THE PROJECTIONS INDICATE SERIOUS DANGER TO THE ECONOMIC RECOVERY, STABILITY OF FINANCIAL MARKETS AND INTEREST RATES, AND THE ECONOMIC WELL BEING OF EVERY AMERICAN.

- THE FOLLOWING TABLE SHOWS A RANGE OF CURRENT SERVICES DEFICIT PATHS BASED ON THE ADMINISTRATION ECONOMIC FORECAST AND TWO ALTERNATIVE FORECASTS:

  - THE ADMINISTRATION FORECAST ASSUMES A RECOVERY BEGINNING IN THE SECOND HALF OF 1982, AN AVERAGE REAL GROWTH RATE OF 4.9% OVER 1983-85, WITH INFLATION FALLING TO 4.6%, UNEMPLOYMENT TO 6.4% AND THE T-BILL TO 8.5% BY 1985.

  - THE HIGHER GROWTH SCENARIO ASSUMES AN AVERAGE REAL GROWTH RATE OF 6.1% OVER THE 1983-85 RECOVERY PERIOD, WITH INFLATION FALLING TO 3.4%, UNEMPLOYMENT TO 4.5% AND THE T-BILL RATE TO 7.3% BY 1985.

- THE LOWER GROWTH SCENARIO ASSUMES AN AVERAGE REAL GROWTH RATE OF 3.7% OVER THE RECOVERY PERIOD 1983-85, WITH INFLATION FALLING TO 5.8%, UNEMPLOYMENT TO 8.3% AND THE T-BILL RATE TO 9.7% BY 1985.

- THE DEFICIT THREAT TO FISCAL BALANCE AND ECONOMIC RECOVERY TRANSCENDS THE PLAUSIBLE RANGE OF ECONOMIC ASSUMPTIONS, AND CANNOT BE MITIGATED WITHOUT COMPREHENSIVE POLICY ACTION. SPECIFICALLY,

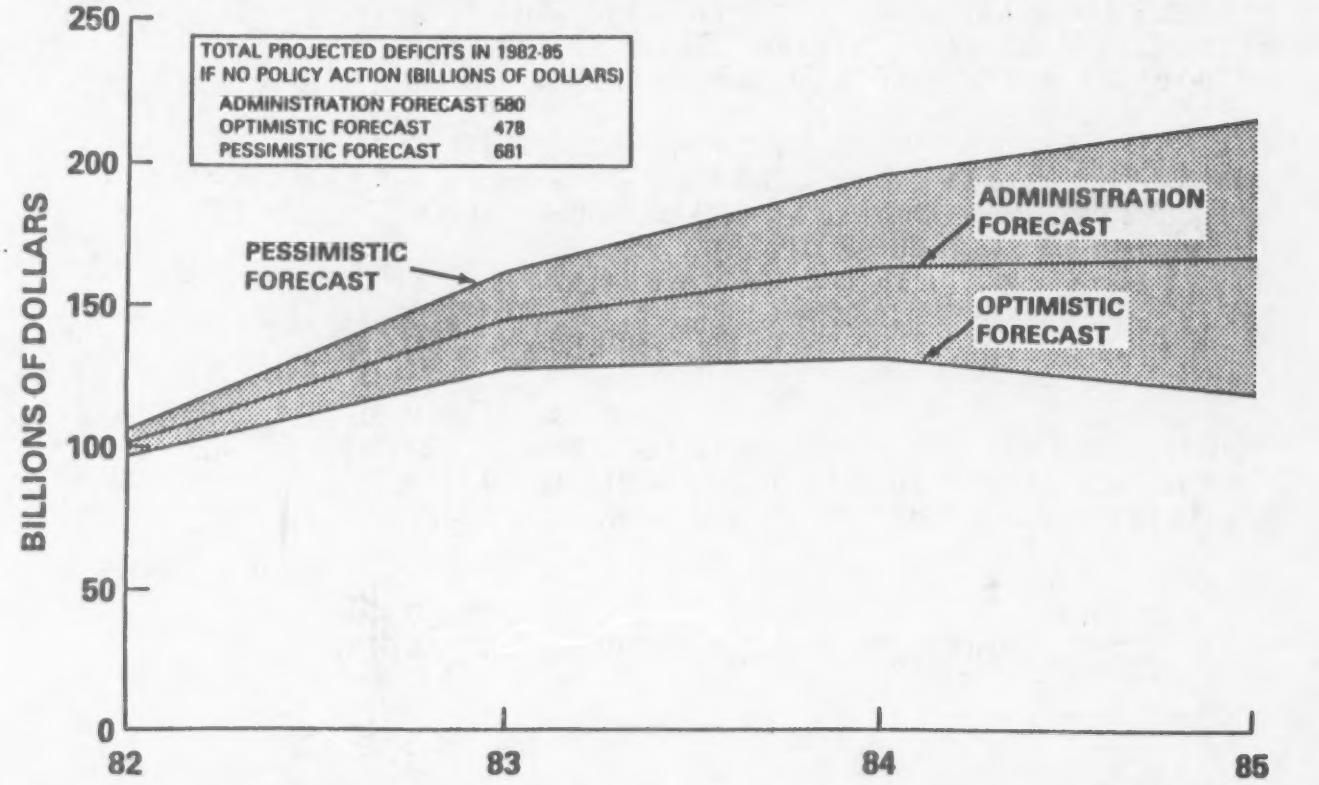
  - THE CURRENT SERVICES DEFICIT EXCEEDS $120 BILLION IN ALL CASES FOR THE FY 83-85 RECOVERY PERIOD;

  - THE SIZE OF THE DEFICIT STEADILY RISES FROM THE FY 82 RECESSION LEVEL;

  - THE CUMULATIVE ADDITION TO THE NATIONAL DEBT RANGES BETWEEN $478 AND $681 BILLION OVER FOUR YEARS.

CURRENT SERVICES DEFICIT PROJECTIONS

(FISCAL YEARS)



III. THE IMPACT OF ECONOMIC TRANSITION: RAPID DETERIORATION OF THE BUDGET OUTLOOK

- THE ECONOMIC OUTLOOK AS VIEWED BY PRACTICALLY ALL ANALYSTS EARLY LAST YEAR DID NOT ANTICIPATE MAJOR DEVELOPMENTS WHICH HAVE DRAMATICALLY ALTERED THE BUDGET PROJECTIONS FOR FY 82 - 85. THESE UNANTICIPATED DEVELOPMENTS INCLUDE:
  - THE PRESENT RECESSION;
  - THE RAPIDLY FALLING RATE OF INFLATION;
  - THE GREATER THAN EXPECTED TIGHTENING OF MONETARY POLICY IN MID-1981 AND THE PROSPECTS FOR SHARPLY REDUCED NOMINAL GNP LEVELS DURING THE RECOVERY PERIOD;
  - THE EMERGENCE OF UNPRECEDENTED PREMIUMS ABOVE THE INFLATION TREND IN NEARLY ALL INTEREST RATES, AND THE PROSPECT THAT THESE PREMIUMS WILL DIMINISH ONLY SLOWLY OVER TIME AS POLICY CREDIBILITY IS RE-ESTABLISHED.

- ALL OF THESE FACTORS REPRESENT ECONOMIC ADJUSTMENT FORCES OPERATING AS THE ECONOMY MOVES FROM A CONDITION OF EXCESSIVE MONEY AND CREDIT GROWTH, UNCONTROLLED FEDERAL SPENDING, RISING INFLATION AND STAGNATING REAL GROWTH TO LOW INFLATION, REVIVED REAL GROWTH AND MONETARY, FINANCIAL AND INTEREST RATE EQUILIBRIUM. ALL ECONOMIC FORECASTS USED LAST YEAR FOR BUDGET PROJECTIONS UNDERESTIMATED THE SEVERITY OF THESE ECONOMIC ADJUSTMENTS AND THEIR ADVERSE CONSEQUENCES FOR THE BUDGETARY OUTLOOOK.

- THE FOLLOWING TABLE COMPARES THE CURRENT ADMINISTRATION DEFICIT PROJECTION -- INCLUDING ALL PROPOSED BUDGET SAVINGS MEASURES -- WITH RE-ESTIMATES OF THE CURRENT BUDGET BASED ON EARLY 1981 ECONOMIC ASSUMPTIONS FROM A VARIETY OF SOURCES. IN EVERY CASE THE DEFICIT PROJECTIONS ARE DRAMATICALLY LOWER BECAUSE THE ECONOMIC ADJUSTMENT FORCES DESCRIBED ABOVE WERE NOT ANTICIPATED. ON AN AVERAGE BASIS, THE CHANGED ECONOMIC OUTLOOK HAS INCREASED THE PROJECTED DEFICIT BY:

  --- $42 BILLION IN FY 82

  --- $59 BILLION IN FY 83

  --- EQUAL OR LARGER AMOUNTS IN THE OUT-YEARS

CURRENT ADMINISTRATION BUDGET RE-ESTIMATED WITH EARLY 1981 ECONOMIC FORECASTS

	82	83	84	85
1) CURRENT ADMINISTRATION DEFICIT ESTIMATE.....	-99	-92	-83	-72
2) CURRENT ADMINISTRATION BUDGET RE-ESTIMATED WITH EARLY 1981 ECONOMIC ASSUMPTIONS:				
CARTER - JANUARY.....	-54	-32	-24	-11
ADMINISTRATION - FEBRUARY.....	-42	-2	+8	+21
DRI - FEBRUARY.....	-63	-46	-47	-23
CBO - MARCH.....	-68	-52	-54	-51
AVERAGE DEFICIT, EARLY 1981 FORECASTS.....	-57	-33	-29	-16

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A) THE TIMING AND SEVERITY OF THE RECESSION WAS NOT ANTICIPATED

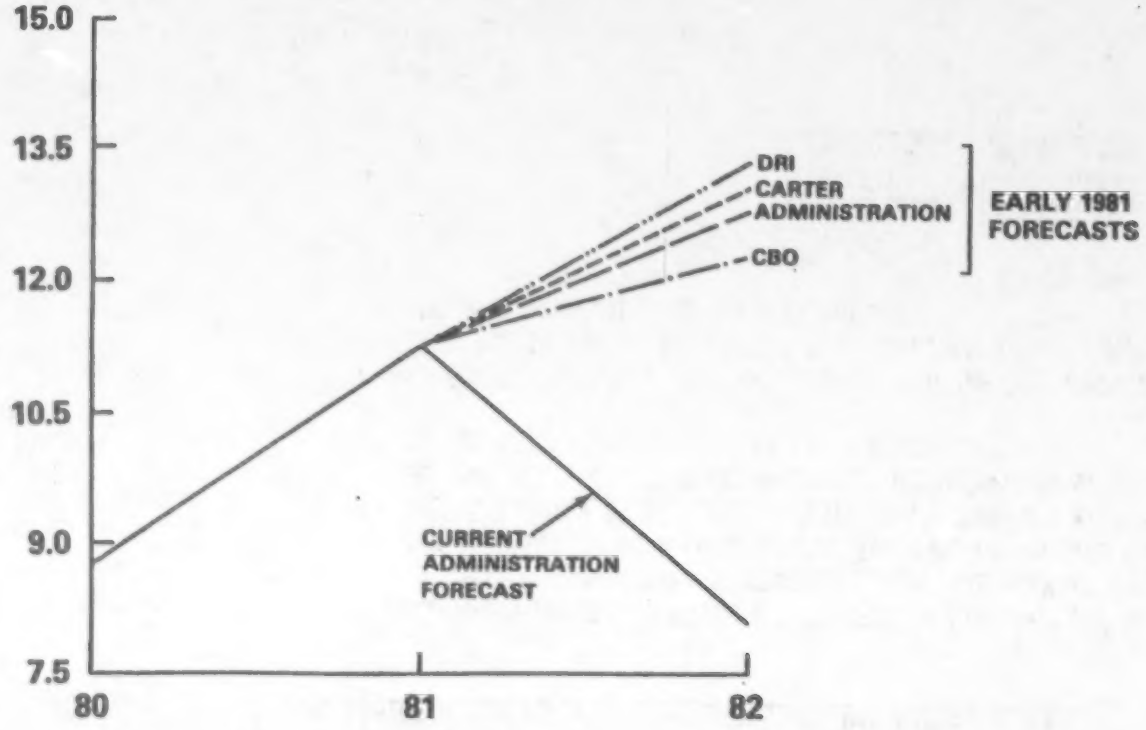
- ALL MAJOR FORECASTS ASSUMED THAT AFTER A FEW SLUGGISH QUARTERS IN 1981, ECONOMIC EXPANSION WOULD RESUME STRONGLY IN THE FALL AND INTO 1982. AS A CONSEQUENCE, THE 1982 GNP GROWTH RATE WAS OVER-ESTIMATED BY 50 - 65 PERCENT. WHEN COMBINED WITH HIGHER UNEMPLOYMENT, FY 82 BUDGET RECEIPTS AND UNEMPLOYMENT RELATED OUTLAY ESTIMATES WERE OFF BY LARGE MAGNITUDES.

- MOREOVER, THE LOWER BASE OF 1982 GNP AND THE RECESSION DRIVEN INCREASE IN THE FY 82 DEFICIT BOTH CARRY-OVER INTO FUTURE BUDGETS, WORSENING THE DEFICIT OUTLOOK:

	FY 1982	
	RECEIPT OVER-ESTIMATE	UNEMPLOYMENT RELATED OUTLAY UNDER-ESTIMATE
	(IN BILLIONS)	
CARTER - JANUARY.....	$38	$7
ADMINISTRATION - FEBRUARY.....	31	8
DRI.....	35	8
CBO - MARCH.....	30	6

GNP GROWTH FORECAST COMPARISON

(PERCENT CHANGE, YEAR OVER YEAR)



B) THE MONETARY LID ON NOMINAL GNP AND RECEIPT GROWTH: THE BUDGETARY IMPACT OF RECOVERY WITHOUT RE-IGNITING INFLATION.

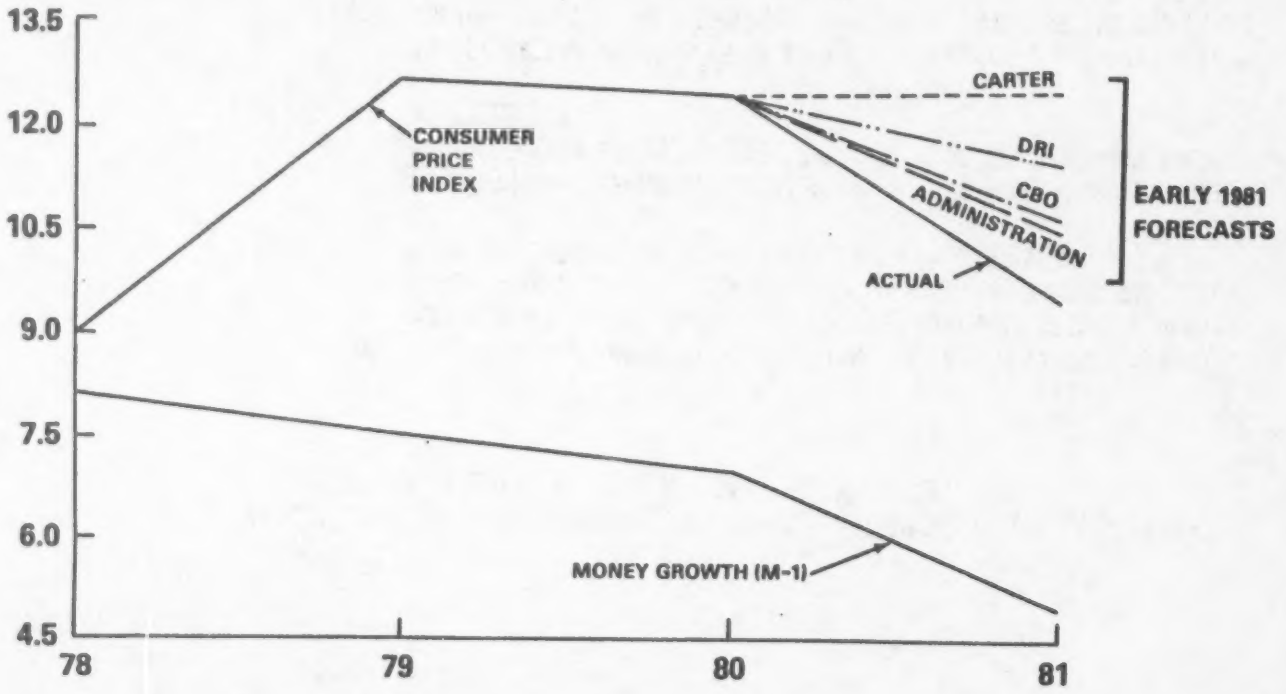
- 1981 MARKED A FUNDAMENTAL DEPARTURE IN THE PREVIOUSLY UPWARD MOVEMENT OF MONEY, PRICES AND THE INFLATIONARY SPIRAL. GROWTH RATES TURNED ABRUPTLY DOWNWARD -- SUBSTANTIALLY MORE RAPIDLY THAN ANTICIPATED IN MOST FORECASTS EARLY LAST YEAR.

- ON A FOURTH-OVER-FOURTH QUARTER BASIS, THE MONEY SUPPLY GROWTH RATE DECLINED BY 30 PERCENT, THE CPI BY 25 PERCENT, AND THE PPI BY 42 PERCENT.

- THE DISINFLATION PROCESS IS CLEARLY UNDERWAY -- BUT THIS WELCOME IMPROVEMENT FOR THE ECONOMY IS A SERIOUS CHALLENGE TO BUDGETARY EQUILIBRIUM DURING THE TRANSITION.

GREATER THAN EXPECTED 1981 DECLINE IN MONEY GROWTH AND INFLATION

(PERCENT CHANGE, 4TH Q OVER 4TH Q)



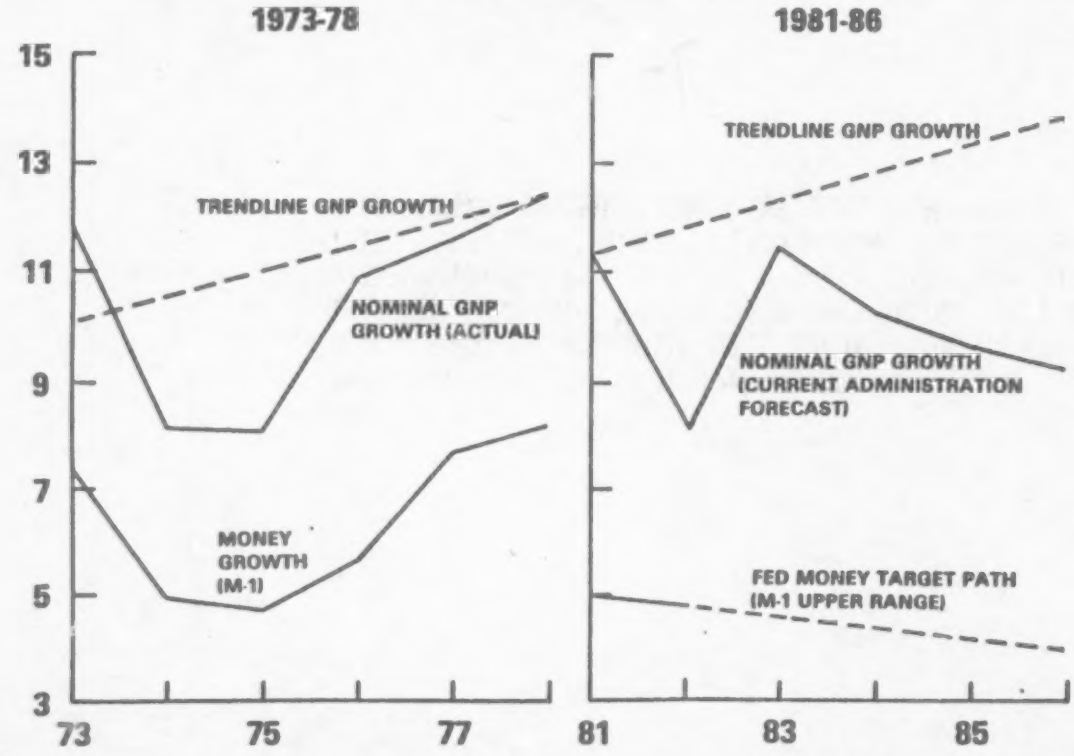
- THIS DRAMATIC PROGRESS IN SLOWING THE GROWTH OF MONEY AND INFLATION MUST BE PRESERVED -- BECAUSE PERMANENT ECONOMIC RECOVERY IS NOT POSSIBLE WITHOUT CONTINUED REDUCTION OF INFLATION. HOWEVER, PRESERVING THESE GAINS ON THE INFLATION FRONT WILL HAVE A PROFOUND IMPACT ON THE COURSE OF THE ECONOMY AND THE BUDGET OVER THE NEXT SEVERAL YEARS OF ECONOMIC RECOVERY AND BUDGET TRANSITION.

- UNLIKE THE PATTERN OF PREVIOUS RECOVERY PERIODS, MONEY SUPPLY GROWTH MUST BE HELD IN CHECK TO AVOID RE-IGNITING INFLATIONARY EXPECTATIONS AND UPWARD PRESSURE ON PRICES. THIS MEANS THAT THERE WILL BE A MONETARY LID ON THE GROWTH RATE OF NOMINAL GNP AND RECEIPTS DURING THE RECOVERY PERIOD.

- BY CONTRAST, DURING THE 1975-78 RECOVERY/RECESSION CYCLE, MONEY SUPPLY GROWTH STEADILY ACCELERATED IN EACH RECOVERY YEAR, RISING FROM 5.0% IN 1975, TO 6.2% IN 1976, TO 8.2% BY 1977. THIS PERMITTED AN EQUALLY RAPID RECOVERY OF NOMINAL GNP GROWTH FROM 8% IN 1975 TO 12.4% BY 1978. THE CONSEQUENCE WAS RISING PRICES AND RAPID INFLATION-FUELED GROWTH OF BUDGETARY RECEIPTS.

- DURING 1982-85, JUST THE OPPOSITE PATTERN WILL OCCUR IF ANTI-INFLATION MONETARY POLICY REMAINS ON TRACK. AFTER THE ANTICIPATED RECOVERY OF NOMINAL GNP IN 1983, THE NOMINAL GNP GROWTH RATE WILL STEADILY FALL -- RATHER THAN RISE -- AS INFLATION IS SQUEEZED OUT OF THE ECONOMY AND THE LID ON MONEY GROWTH IS MAINTAINED. THIS LID ON MONEY GROWTH, INFLATION AND NOMINAL GNP MEANS THERE WILL BE NO INFLATION-FUELED GROWTH OF BUDGET RECEIPTS AS HAS OCCURRED DURING RECENT BUSINESS CYCLES.

IMPACT OF MONETARY LID ON GNP GROWTH

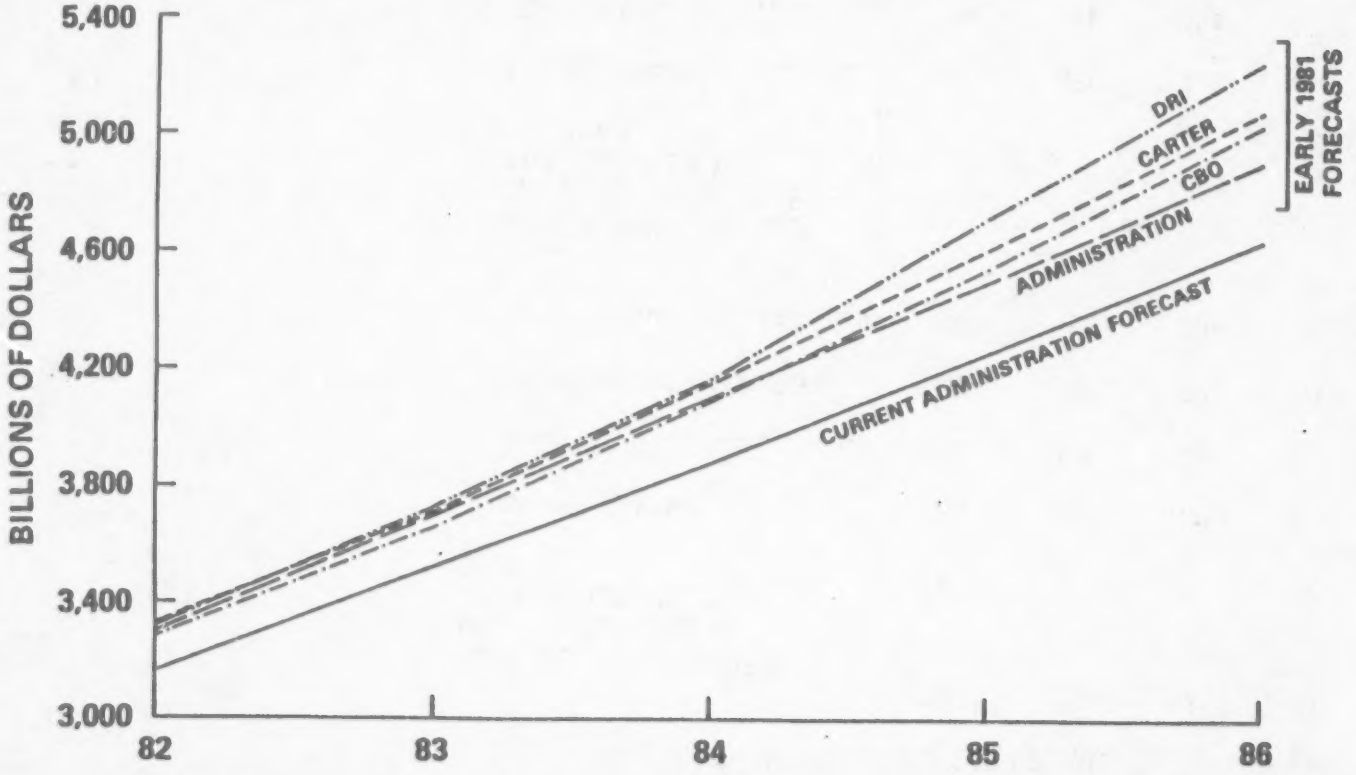


- THIS ANTI-INFLATION LID ON MONEY GROWTH, NOMINAL GNP AND BUDGET RECEIPTS WAS NOT ACCURATELY REFLECTED IN ANY OF THE EARLY 1981 FORECASTS, INCLUDING THAT OF THE ADMINISTRATION. IN COMBINATION WITH THE FAILURE TO PREDICT THE MUCH LOWER 1982 RECESSION GNP LEVEL, THIS MEANS THAT 1983-85 NOMINAL GNP LEVELS AND BUDGETARY RECEIPTS WERE DRASTICALLY OVER-ESTIMATED BY ALL FORECASTS.

MAGNITUDE OF GNP AND RECEIPT OVER-ESTIMATE

	1982	1983	1984	1985
I. EARLY 1981 OVER-ESTIMATE OF GNP RELATIVE TO CURRENT ADMINISTRATION FORECAST (BILLIONS)				
CARTER - JANUARY.....	$152	$194	$273	$353
CBO - MARCH.....	116	139	208	291
ADMINISTRATION - FEBRUARY.....	133	176	215	242
DRI - FEBRUARY.....	150	198	286	467
II. EARLY 1981 OVER-ESTIMATE OF RECEIPTS RELATIVE TO CURRENT ADMINISTRATION FORECAST (BILLIONS)				
CARTER - JANUARY.....	$38	$57	$69	$84
CBO - MARCH.....	30	51	54	71
ADMINISTRATION - FEBRUARY.....	31	53	57	60
DRI - FEBRUARY.....	35	60	69	106

CHANGE IN GNP OUTLOOK

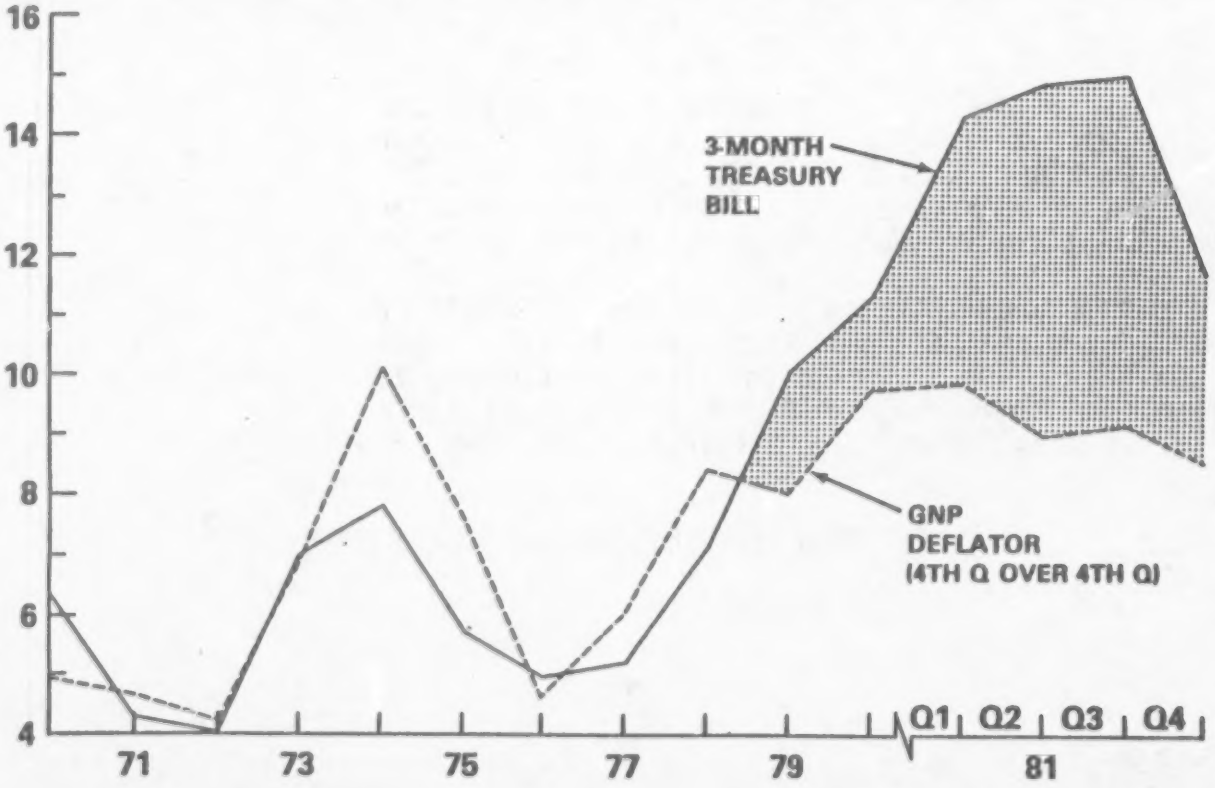


C) INTEREST PREMIUMS AND FINANCIAL MARKET TRANSITION

- THROUGHOUT THE 1970'S, THE RISE OF THE INTEREST RATES JUST PARALLELED THE RISE OF INFLATION AND IN MANY YEARS LAGGED BEHIND IT. IN THE T-BILL MARKET, THE AVERAGE REAL INTEREST RATE WAS ACTUALLY NEGATIVE -- MEANING THAT FOR A GOOD PART OF THE DECADE THE FEDERAL DEBT WAS FINANCED AT A NEGATIVE RATE OF RETURN.

- BUT AS THE INFLATION AND FINANCIAL DISORDER WORSENED IN 1979-80, THE FINANCIAL MARKETS ADJUSTED, LONG-TERM LENDING DRIED-UP AND HUGE PREMIUMS ABOVE THE INFLATION RATE APPEARED IN SECURITIES THROUGHOUT THE MATURITY SPECTRUM. THESE PREMIUMS REACHED UNPRECEDENTED SIZE THROUGHOUT 1981.

THE CHANGE IN TREASURY BILL — INFLATION RELATIONSHIP



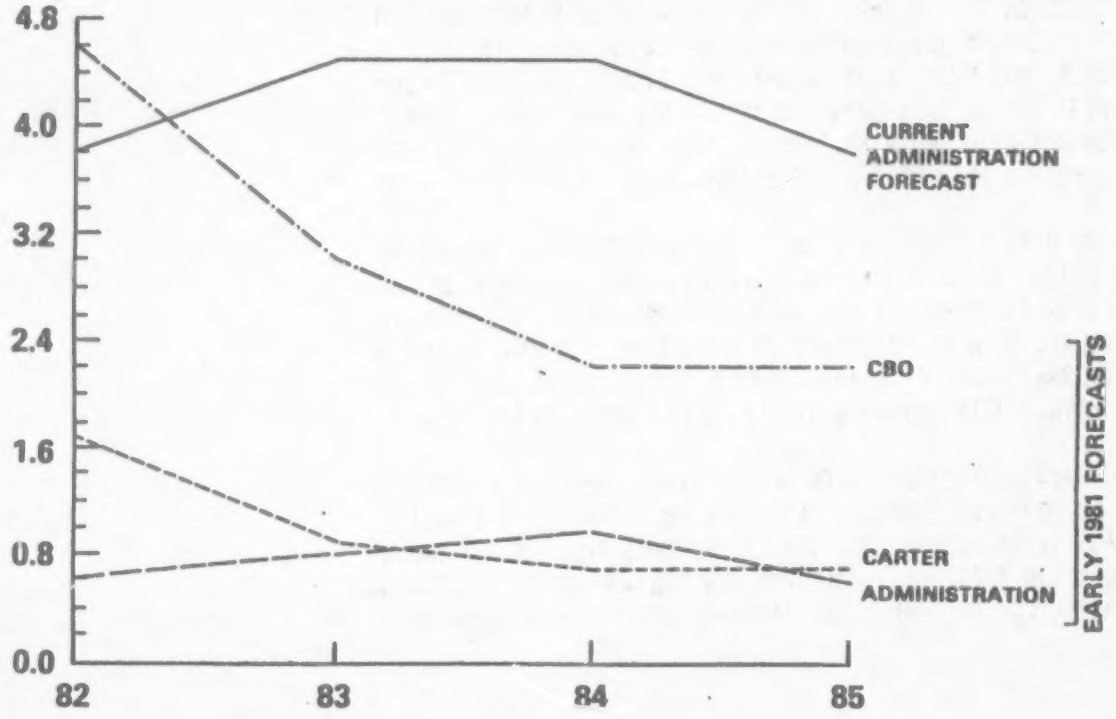
- FORECASTS ISSUED EARLY IN 1981, INCLUDING THE ADMINISTRATION FORECAST, GENERALLY DID NOT ANTICIPATE THE SIZE OF THESE PREMIUMS, NOR DID THEY ANTICIPATE THEY WOULD PERSIST OVER AN EXTENDED DURATION. AS A RESULT, INTEREST RATE LEVELS WERE SERIOUSLY UNDER-ESTIMATED ALONG WITH INTEREST RELATED OUTLAYS.

- IT NOW APPEARS THAT INTEREST RATE PREMIUMS WILL REMAIN "STICKY" DURING THE TRANSITION TO LOWER INFLATION. WHILE PROGRESS IN REDUCING INTEREST RATES CAN BE EXPECTED, IT WILL TAKE TIME TO RESTORE LONG-TERM FINANCIAL CONFIDENCE, REFINANCE SHORT-TERM BUSINESS AND HOUSEHOLD LIABILITIES AND TO BRING CREDIT DEMANDS, INCLUDING GOVERNMENT DEMANDS, AND AVAILABILITY INTO BALANCE.

- AS A CONSEQUENCE, THE ADMINISTRATION'S CURRENT FORECAST ASSUMES SUBSTANTIALLY LARGER INTEREST RATE PREMIUMS OVER THE NEXT SEVERAL YEARS THAN DID ALMOST ALL FORECASTS OF ONE YEAR AGO. RATHER THAN THE TRADITIONAL 1-2 PERCENT INFLATION/INTEREST SPREAD, THE CURRENT ADMINISTRATION FORECAST ASSUMES A 4% OR GREATER SPREAD OR PREMIUM THROUGH 1984, WITH A STEADY DECLINE THEREAFTER.

INTEREST RATE PREMIUM

(T-BILL RATE MINUS GNP DEFLATOR)



- GIVEN THE IMPROVING OUTLOOK FOR INFLATION, THE ADMINISTRATION FORECAST NEVERTHELESS PROJECTS A STEADY FALL IN THE INTEREST RATE FROM THE 11.7% T-BILL LEVEL PROJECTED FOR 1982 TO 9.5% BY 1984 AND LOWER THEREAFTER. THIS IS A SUBSTANTIALLY HIGHER PATH THAN PROJECTED LAST YEAR, AND WILL INCREASE INTEREST-RATE RELATED OUTLAYS BY $8 BILLION IN FY 82 AND $54 BILLION OVER FY 83-85.

- WHILE OTHER EARLY 1981 FORECASTS ASSUMED A HIGHER NOMINAL T-BILL RATE, THEY ALSO PROJECTED EXCESSIVE LEVELS OF INFLATION, NOMINAL GNP AND BUDGETARY RECEIPTS. WHEN ALL FORECAST FACTORS ARE REDUCED TO THE BOTTOM LINE -- ADDED DEFICIT AND INCREASED FUTURE YEAR DEBT -- THE CONCLUSION IS THE SAME: DEBT-SERVICE OUTLAYS DUE TO LARGER DEFICITS WILL BE SUBSTANTIALLY HIGHER EVEN IF THE ADMINISTRATION'S COMPLETE BUDGET SAVINGS PROGRAM IS ADOPTED.

OUTLAY INCREASE DUE TO ADDED DEBT RESULTING FROM ALL CHANGES BETWEEN EARLY 1981 FORECASTS AND THE CURRENT ADMINISTRATION FORECAST:

	FY83	FY84	FY85	TOTAL
CARTER - JANUARY.....	8	13	17	38
CBO - MARCH.....	6	8	10	24
ADMINISTRATION - FEBRUARY.....	16	18	19	53
DRI - FEBRUARY.....	6	10	13	29

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D) THE IMPACT OF ECONOMIC TRANSITION ON THE BUDGET OUTLOOK: CURRENT VS. ORIGINAL ADMINISTRATION PROJECTIONS

- THE FOREGOING MAKES CLEAR THAT THE ORIGINAL ADMINISTRATION ECONOMIC AND BUDGET FORECAST -- ALONG WITH ALL OTHERS ISSUED EARLY LAST YEAR -- DID NOT ANTICIPATE THE GALE-LIKE FORCES THAT A SLOW-DOWN IN MONEY, CREDIT AND NATIONAL INCOME GROWTH, AND THE RESULTING FINANCIAL AND ECONOMIC ADJUSTMENTS, WOULD UNLEASH ON THE BUDGET. IT IS NOW CLEAR THAT THE PROCESS OF DISINFLATION WORKS POWERFULLY AGAINST BUDGETARY EQUILIBRIUM -- AT LEAST FOR AN INTERIM PERIOD OF TIME -- AND THAT THE CHALLENGES OF FISCAL POLICY MANAGEMENT HAVE BECOME DECIDEDLY MORE INTENSE.

- IT IS THIS DISINFLATION PROCESS THAT IS LARGELY RESPONSIBLE FOR THE DRAMATIC DETERIORATION OF THE BUDGET OUTLOOK SINCE LAST YEAR.

- THE MORE ABRUPT THAN EXPECTED SLOW-DOWN IN MONEY GROWTH BETWEEN 1980 AND 1981 (7.2% IN 1980 VS 4.9% IN 1981) IN THE CONTEXT OF ACCUMULATED FINANCIAL WEAKNESS AND DEPRESSED LONG-TERM CAPITAL MARKETS -- TRIPPED THE ECONOMY INTO A TEMPORARY RECESSION AND CORRECTION OF UNDERLYING FINANCIAL AND ECONOMIC IMBALANCES.

- THE RESULTING HIGHER INTEREST RATES AND BORROWING HAVE ADDED $17 BILLION TO FY 82 OUTLAYS. THE RESULTING RECESSION HAS FURTHER REDUCED RECEIPTS BY $31 BILLION AND RAISED UNEMPLOYMENT RELATED OUTLAYS BY $8 BILLION COMPARED TO LAST YEAR'S PROJECTION. THIS $57 BILLION CHANGE DRIVEN BY ECONOMIC FORCES ACCOUNTS FOR THE ENTIRE INCREASE IN THE FY 82 DEFICIT FROM THE ORIGINAL PROJECTIONS. IN ADDITION, THE BUDGETARY SPILL-OVER INTO THE OUT-YEARS FROM THE FY 82 ECONOMIC AND BUDGET DETERIORATION COMPOUNDS THE PROBLEM OF REDUCING FUTURE DEFICITS.

- AS THE RECOVERY GATHERS FORCE THROUGH 1983 AND 1984, THE ANTI-INFLATION MONETARY POLICY WILL IMPOSE A "LID" ON THE RECOVERY OF NOMINAL GNP AND BUDGETARY RECEIPTS. THUS, THE BUDGET RECEIPT PROJECTION HAS BEEN SUBSTANTIALLY REDUCED SINCE LAST YEAR. RECEIPTS WILL BE $53 BILLION LOWER IN FY 83 AND $170 BILLION LOWER OVER FY 83-85. AS A CONSEQUENCE, INHERITED OR NEW SPENDING COMMITMENTS CANNOT BE FINANCED WITH INFLATION-FUELED GROWTH OF RECEIPTS DURING THE RECOVERY PERIOD, AS OCCURRED IN 1975-78 AND PREVIOUS BUSINESS CYCLES.

- THE $249 BILLION IN INDEXED PROGRAMS IN FY 1983 WILL RESPOND TO LOWER INFLATION -- BUT ONLY WITH A LAG DUE TO THE BASE PERIOD ADJUSTMENT MECHANISM. THE DIFFERENCE BETWEEN CONTEMPORANEOUS AND LAGGED ADJUSTMENT WILL INCREASE OUTLAYS BY $5 BILLION IN FY 83 AND $8 BILLION IN FY 85.

- THE RECESSION INDUCED RISE OF UNEMPLOYMENT TO THE 9% RANGE WILL ADD FURTHER PRESSURE TO THE BUDGET -- AS THE RECOVERY SPURRED DROP IN UNEMPLOYMENT WILL START FROM A HIGHER LEVEL AND TAKE LONGER TO REDUCE THAN ANTICIPATED LAST YEAR. SAFETY NET RELATED OUTLAYS WILL BE $14 BILLION HIGHER OVER FY 83-85 AS A CONSEQUENCE.

- THE RESTORATION OF FINANCIAL MARKET CONFIDENCE AND STABILITY WILL TAKE MORE TIME THAN PREVIOUSLY ANTICIPATED, RESULTING IN HIGHER INTEREST RATE PREMIUMS THAN PREVIOUSLY FORECAST. WHILE IT IS EXPECTED THAT T-BILL RATES WILL STEADILY FALL FROM CURRENT PEAKS, T-BILL LEVELS OVER FY 83-85 ARE NOW PROJECTED TO AVERAGE 260 BASIS POINTS HIGHER THAN PROJECTED LAST YEAR. THIS WILL INCREASE INTEREST-RATE RELATED OUTLAYS BY $15 BILLION IN FY 83 AND $54 BILLION OVER THE THREE-YEAR PERIOD.

- ALL OF THESE FORCES ACTING TOGETHER ADD TO CURRENT YEAR DEFICITS AND RAISE THE AMOUNT OF DEBT TO BE FINANCED IN OUT-YEARS. EVEN ASSUMING FULL ENACTMENT OF THE FY 83 BUDGET PROGRAM, ADDED INTEREST AND DEBT SERVICE OUTLAYS WILL REACH $31 BILLION IN FY 83 AND $107 BILLION OVER FY 83-85, COMPARED TO LAST YEAR'S FORECAST.

- THE HUGE DIFFERENCES IN BUDGET AND DEFICIT ESTIMATES SHOWN IN THE TABLE DUE TO THE CHANGE IN THE ECONOMIC OUTLOOK SINCE LAST FEBRUARY ARE NOT UNIQUE TO THE ADMINISTRATION'S ORIGINAL FORECAST, AS WAS DEMONSTRATED PREVIOUSLY.

COMPARISON OF FEBRUARY 1981 AND CURRENT ADMINISTRATION ECONOMIC ASSUMPTIONS
(CALENDAR YEAR, DOLLAR AMOUNTS IN BILLIONS)

	1981	1982	1983	1984	1985	1986
NOMINAL GNP:						
1981 FORECAST.....	2,920	3,293	3,700	4,098	4,500	4,918
1982 FORECAST.....	2,922	3,160	3,524	3,883	4,258	4,651
REAL GNP (PERCENT CHANGE):						
1981 FORECAST.....	1.1	4.2	5.0	4.5	4.2	4.2
1982 FORECAST.....	2.0	0.2	5.2	5.0	4.7	4.4
GNP DEFLATOR (PERCENT CHANGE):						
1981 FORECAST.....	9.9	8.3	7.0	6.0	5.4	4.9
1982 FORECAST.....	9.1	7.9	6.0	5.0	4.7	4.6
INTEREST RATE ON 91-DAY TREASURY BILLS (PERCENT):						
1981 FORECAST.....	11.1	8.9	7.8	7.0	6.0	5.6
1982 FORECAST.....	14.1	11.7	10.5	9.5	8.5	7.0
UNEMPLOYMENT RATE (PERCENT).						
1981 FORECAST.....	7.8	7.2	6.6	6.4	6.0	5.6
1982 FORECAST.....	7.6	8.9	7.9	7.1	6.4	5.8

EFFECTS ON THE BUDGET OF CHANGES IN ECONOMIC ASSUMPTIONS SINCE MARCH 1981
(IN BILLIONS OF DOLLARS)

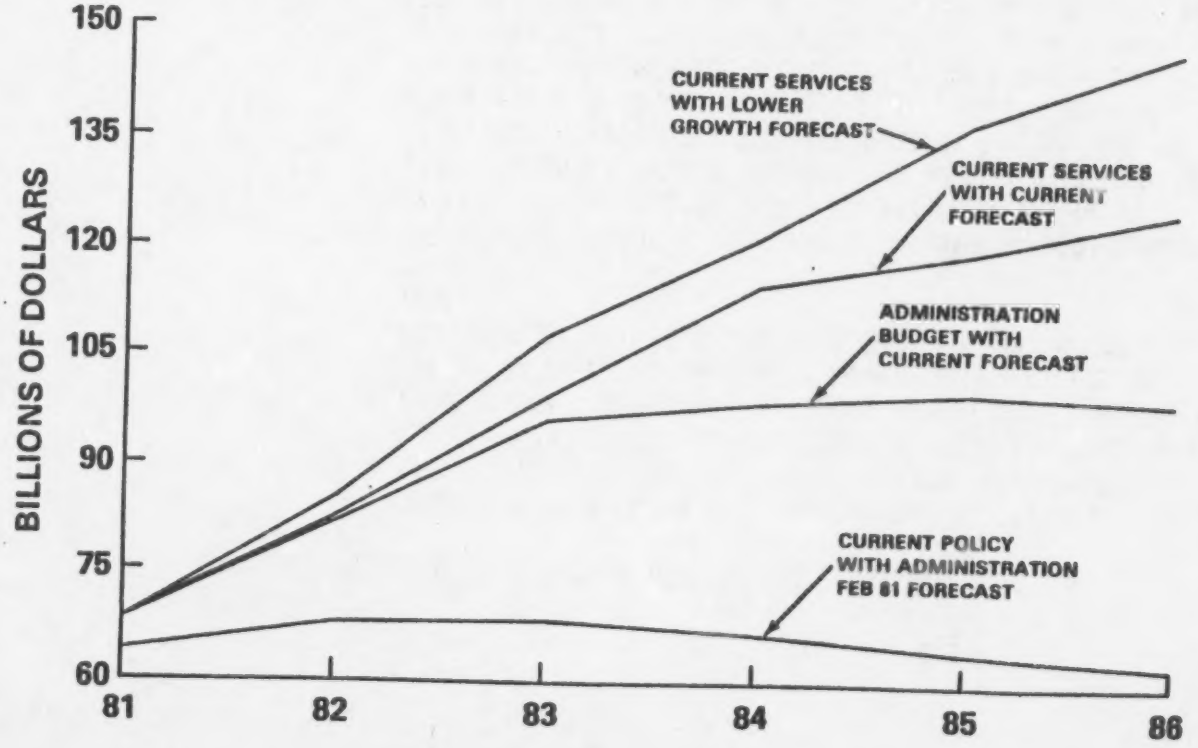
	1982	1983	1984	1985	1986
CURRENT BUDGET ESTIMATES ADJUSTED TO MARCH 1981 FORECAST:					
RECEIPTS	657.7	718.7	779.7	856.9	922.7
OUTLAYS	699.4	721.1	771.2	836.1	897.5
DEFICIT (-)	-41.7	-2.4	8.5	20.8	25.2
CHANGES DUE TO ECONOMIC ASSUMPTIONS:					
RECEIPTS	-31.0	-52.6	-56.7	-60.3	-61.7
OUTLAYS:					
INFLATION	1.5	-2.1	-5.7	-9.8	-11.9
UNEMPLOYMENT	7.9	7.4	4.4	2.3	0.9
INTEREST RATES AND DEFICITS	16.6	31.1	36.0	39.8	40.5
TOTAL	25.9	36.5	34.7	32.4	29.5
TOTAL INCREASE IN DEFICIT (-)	-56.9	-89.1	-91.4	-92.6	-91.2
CURRENT BUDGET ESTIMATES:					
RECEIPTS	626.8	666.1	723.0	796.6	861.0
OUTLAYS	725.3	757.6	805.9	868.5	927.0
DEFICIT (-)	-98.6	-91.5	-82.9	-71.9	-66.0

E) THE POTENTIAL EXPLOSION OF DEBT SERVICES COSTS

- CHANGES IN CURRENT AND EXPECTED ECONOMIC CONDITIONS ACCOUNT FOR THE HIGH DEFICITS PROJECTED EVEN AFTER THE ADMINISTRATION'S FY 83 BUDGET SAVINGS PROGRAM. BUT IT MUST BE CLEARLY RECOGNIZED THAT THESE DEFICIT INCREASING FORCES HAVE AN EXPLOSIVE POTENTIAL FOR FURTHER EXACERBATING THE BUDGET IMBALANCE IF DECISIVE AND COMPREHENSIVE DEFICIT REDUCTION ACTIONS ARE NOT IMPLEMENTED THIS YEAR.

- THE INCREASED INTEREST RATES AND DEBT FINANCING REQUIREMENTS FOR FY 83-85 ADD $94 BILLION TO THE PROJECTION OF NET INTEREST OUTLAYS COMPARED TO LAST FEBRUARY. IF NO ACTION IS TAKEN ON THE FY 83 BUDGET SAVINGS PROGRAM, NET INTEREST OUTLAYS OVER THE THREE YEARS WILL RISE BY ANOTHER $33 BILLION. AND IF ECONOMIC PERFORMANCE WEAKENS UNDER THE BURDEN OF THESE DEBT FINANCING REQUIREMENTS TO THE LOWER-GROWTH/HIGHER INFLATION SCENARIO DESCRIBED ON PAGE 4 -- ANOTHER $37 BILLION WOULD BE ADDED TO DEBT SERVICE COSTS OVER THE NEXT THREE YEARS.

POTENTIAL EXPLOSION OF DEBT — SERVICE OUTLAYS



IV. THE FISCAL POLICY ALTERNATIVES CONSIDERED BY CONGRESS LAST YEAR WOULD HAVE HAD A SIMILAR IMPACT ON THE CURRENT BUDGET OUTLOOK: SIMILAR, LARGE CURRENT SERVICES DEFICITS RESULT FROM EITHER THE ADMINISTRATION PROGRAM AS ADOPTED OR THE HOUSE WAYS AND MEANS AND BUDGET COMMITTEE TAX AND SPENDING POLICY ALTERNATIVES THAT WERE REJECTED.

- THE TABLE BELOW PROVIDES A CURRENT SERVICES PROJECTION OF MAJOR SPENDING AND TAX POLICY OPTIONS CONSIDERED AND REJECTED BY THE CONGRESS LAST YEAR COMPARED TO THE CURRENT SERVICES PROJECTION OF THE ADMINISTRATION PROGRAM AS ENACTED. BOTH BUDGET PROJECTIONS ARE BASED ON THE CURRENT ADMINISTRATION ECONOMIC FORECAST.

- HAD THE FIRST BUDGET RESOLUTION SPENDING POLICY RECOMMENDATIONS PROPOSED BY THE HOUSE BUDGET COMMITTEE LAST YEAR BEEN ADOPTED, AGGREGATE CURRENT SERVICES OUTLAY PROJECTIONS WOULD HAVE BEEN SIMILAR -- EXCEPT FOR A MODEST RE-ALLOCATION OF OUTLAYS FROM DEFENSE TO NON-DEFENSE PROGRAMS.

- HAD THE WAYS AND MEANS COMMITTEE TAX BILL HAVE BEEN ADOPTED, THE THIRD-YEAR OF THE INDIVIDUAL RATE CUT WOULD NOT LIKELY BE TRIGGERED IN JANUARY 1984 AS PROVIDED BY THE BILL. NEVERTHELESS, DUE TO OTHER PROVISIONS OF THE WAYS AND MEANS ALTERNATIVE THE FY 82-84 STATIC REVENUE COST WOULD HAVE BEEN SIMILAR:

	($ BILLIONS)
ECONOMIC RECOVERY TAX ACT REVENUE COST, FY 82-84.....	$-289
WAYS AND MEANS TAX ALTERNATIVE FY 82-84 WITHOUT THIRD YEAR RATE CUT.....	$-253

- AS A CONSEQUENCE, CURRENT SERVICES DEFICIT PROJECTIONS FOR FY 82-84 ARE NEARLY IDENTICAL WHEN BASED ON COMMON ECONOMIC ASSUMPTIONS. IN BOTH CASES, A LARGE, UNANTICIPATED FISCAL PROBLEM LOOMS ON THE HORIZON DUE TO CHANGED ECONOMIC CIRCUMSTANCES AND OUTLOOK.

- THE DEFICIT CAN BE REDUCED IF THE DEBATE FOCUSES ON THE COMMON PROBLEM AT HAND AND THE POTENTIAL BUDGET SAVINGS OPTIONS AVAILABLE. RE-OPENING THE DEBATE ON PAST POLICY CHOICES -- BOTH OF WHICH APPROPRIATELY AND IRREVERSIBLY MOVED THE NATION FORWARD ON A CONSTRUCTIVE PATH OF LOWER TAXES AND REDUCED SPENDING GROWTH -- WILL NEITHER SOLVE NOR EXPLAIN OUR CURRENT FISCAL POLICY CHALLENGES.

CURRENT SERVICES BUDGET ESTIMATES: ENACTED ADMINISTRATION PROGRAM VS. 1981 CONGRESSIONAL ALTERNATIVES

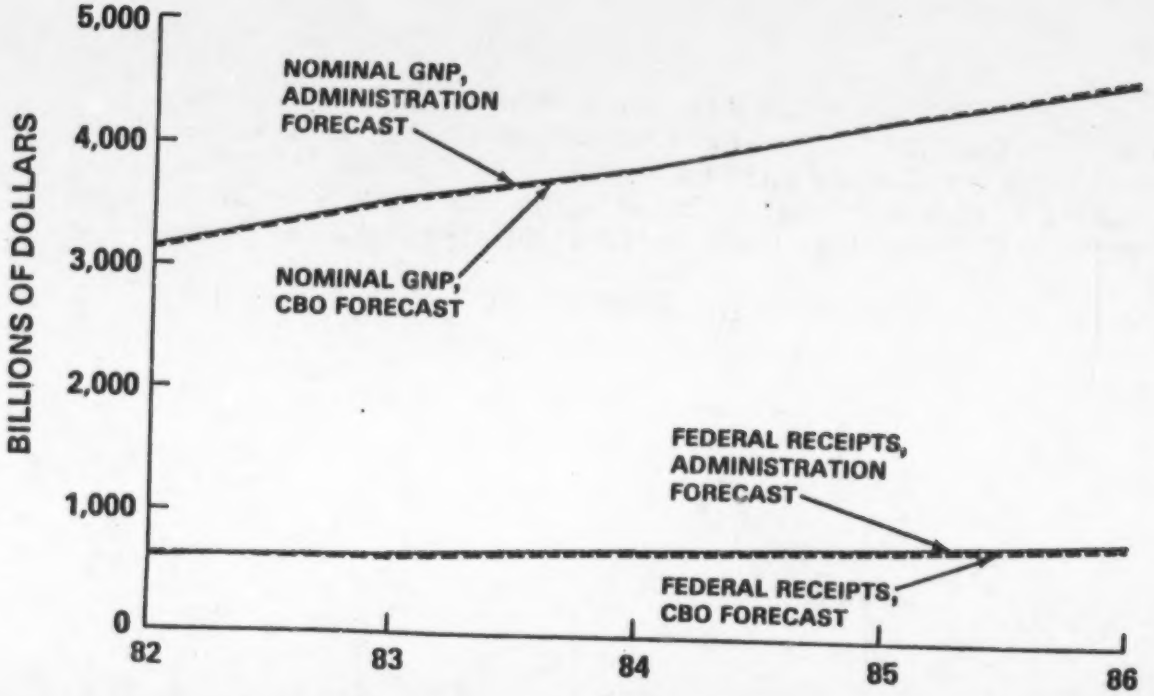
(BILLIONS OF $)

	FY-82	FY-83	FY-84
OUTLAYS:			
ADMINISTRATION CURRENT SERVICES ESTIMATE:.....	728	799	869
POLICY DIFFERENCES IN 1981 HBC FIRST BUDGET RESOLUTION:			
NON-DEFENSE INCREASES.....	+7	+7	+7
DEFENSE REDUCTIONS.....	--	-5	-6
CURRENT SERVICES ESTIMATE WITH HBC SPENDING POLICY ALTERNATIVE.....	735	801	870
RECEIPTS:			
ADMINISTRATION CURRENT SERVICES ESTIMATE:.....	626	653	704
POLICY DIFFERENCES IN 1981 WAYS AND MEANS TAX ALTERNATIVE.....	+ 2	- 2	+17
CURRENT SERVICES RECEIPTS WITH WAYS AND MEANS TAX ALTERNATIVE.....	628	651	721
DEFICIT:			
ADMINISTRATION CURRENT SERVICES DEFICIT.....	-102	-147	-167
CURRENT SERVICES DEFICIT WITH HBC SPENDING AND WAYS AND MEANS TAX ALTERNATIVE.....	-107	-150	-149

V. THE 1982 FORECAST ISSUES: CBO VS. ADMINISTRATION ASSUMPTIONS

- ON THE MAJOR VARIABLE WHICH DRIVES THE BUDGET AND DEFICIT -- NOMINAL GNP -- THERE ARE NO SIGNIFICANT DIFFERENCES BETWEEN THE ADMINISTRATION AND CBO FORECASTS. GNP LEVELS AND CURRENT LAW RECEIPT ESTIMATES ARE NEARLY IDENTICAL FOR FY 82-84, WITH CBO SOMEWHAT LOWER IN FY 85. AS NOTED PREVIOUSLY, BOTH EMBODY SUBSTANTIAL DOWNWARD ESTIMATES FROM LAST YEAR'S ASSUMPTIONS.

IMPACT OF ADMINISTRATION AND CBO FORECASTS: DIFFERENCE ON GNP AND RECEIPTS



- A SIGNIFICANT DIFFERENCE IN TERMS OF BUDGETARY IMPACT IS FOUND IN THE COMPOSITION OF NOMINAL GNP -- THE SPLIT BETWEEN REAL GROWTH AND INFLATION. ESSENTIALLY, CBO ASSUMES A SIGNIFICANTLY LOWER REAL GROWTH RATE AND A HIGHER INFLATION RATE.

- FOR THE SIX INITIAL RECOVERY QUARTERS BEGINNING IN 1982:3, THE ADMINISTRATION AND CBO GNP GROWTH RATES COMPARE WITH HISTORICAL RECOVERY PERIODS AS FOLLOWS:

	AVERAGE REAL GNP GROWTH, SIX INITIAL RECOVERY QUARTERS
ADMINISTRATION.....	5.4%
CBO.....	4.5
1975 - 1976.....	5.3
1970 - 1971.....	5.6
1961 - 1962.....	6.0
1958 - 1959.....	5.7
AVERAGE, ALL POST-WAR RECOVERIES.....	5.6%

- FOR THE ENTIRE 22 QUARTER PERIOD OF REAL EXPANSION BEGINNING IN 1982:2 THROUGH 1987, THE ADMINISTRATION AND CBO FORECASTS COMPARE AS FOLLOWS:

	22 QUARTER AVERAGE REAL GROWTH (%)
ADMINISTRATION.....	4.7
CBO.....	3.1
AVERAGE, 1947 - 1981.....	3.5
AVERAGE, 1961 - 1966.....	5.4

- COMPARED WITH ALL TWENTY-TWO-QUARTER PERIODS (118 SEPARATE OBSERVATIONS) BETWEEN 1947 - 1981, THE CBO AND ADMINISTRATION REAL GROWTH FORECASTS COMPARE AS FOLLOWS:

	NUMBER OF PERIODS ABOVE	NUMBER OF PERIODS BELOW
ADMINISTRATION.....	22	96
CBO.....	73	45

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- BOTH THE ADMINISTRATION AND CBO FORECASTS ASSUME SUBSTANTIAL INTEREST PREMIUMS OVER THE 1983-85 PERIOD. HOWEVER, SINCE THE CBO FORECAST ASSUMES LOWER GROWTH AND HIGHER INFLATION, CBO T-BILL LEVELS ARE SUBSTANTIALLY HIGHER IN EACH OF THE THREE YEARS:

INTEREST PREMIUM (%)

	1983	1984	1985
CBO.....	5.9	4.7	3.4
ADMINISTRATION.....	4.5	4.5	3.8

T-BILL LEVEL (%)

	1983	1984	1985
CBO.....	13.2	11.3	9.4
ADMINISTRATION.....	10.5	9.5	8.5

- THE OVERALL IMPACT ON THE BUDGET AND DEFICIT PROJECTIONS OF THESE DIFFERENCES IN FORECAST ASSUMPTIONS IS MODEST FOR FY 82-83, BUT OF SIGNIFICANT MAGNITUDE FOR FY 83-84:

	FY 82	FY 83	FY 84	FY 85
ADMINISTRATION DEFICIT ESTIMATE.....	-98.6	-91.5	-82.9	-71.9
WITH CBO ECONOMIC ASSUMPTIONS.....	-104.5	-98.8	-104.7	-103.7
DIFFERENCE.....	5.9	7.3	21.8	31.8

- WHILE THESE CURRENT FORECAST DIFFERENCES HAVE SIGNIFICANT BUDGETARY IMPACT IN THE OUT-YEARS, THEIR MAGNITUDE IS SUBSTANTIALLY OVER-SHADOWED BY THE DEFICIT IMPACT OF THE ADMINISTRATION'S FIVE-PART BUDGET SAVINGS PLAN. THUS, FORECAST ISSUES ARE IMPORTANT, BUT THE ULTIMATE SIZE OF THE DEFICIT AND ITS IMPACT ON THE ECONOMIC RECOVERY WILL DEPEND UPON SUCCESSFUL POLICY ACTION TO REFORM ENTITLEMENTS, HOLD-DOWN DISCRETIONARY SPENDING, ELIMINATE TAX LOOPHOLES AND IMPLEMENT USER FEES AND MANAGEMENT INITIATIVES:

	FY-83	FY-84	FY-85	TOTAL FY-83-85
DEFICIT ADD-ON DUE TO CBO ECONOMIC ASSUMPTIONS.....	+7	+22	+32	+61
DEFICIT REDUCTION DUE TO ADMINISTRATION FIVE-PART BUDGET SAVINGS PROGRAM.....	-56	-84	-99	-239

ADMINISTRATION BUDGET DEC...

CBO ECONOMIC ASSUMPTIONS

	82	83	84	85
I. OUTLAYS				
ADMINISTRATION OUTLAYS	725.3	757.6	805.9	868.5
RE-ESTIMATES FOR CBO ASSUMPTIONS:				
HIGHER INTEREST RATES	1.0	1.5	11.1	9.2
HIGHER DEBT	0.2	1.1	2.4	5.3
HIGHER UNEMPLOYMENT	--	1.2	2.2	4.7
HIGHER INFLATION	--	1.2	5.5	14.9
OUTLAYS WITH CBO ASSUMPTIONS 1/	726.5	762.6	827.1	902.6
II. RECEIPTS				
ADMINISTRATION RECEIPTS	626.8	666.1	723.0	796.6
RE-ESTIMATES FOR CBO ECONOMIC ASSUMPTIONS.	-4.8	-2.3	-0.6	2.3
RECEIPTS WITH CBO ASSUMPTIONS 1/	622.0	663.8	722.4	798.9
III. DEFICIT				
ADMINISTRATION ESTIMATE	-98.6	-91.5	-82.9	-71.9
RE-ESTIMATE WITH CBO ECONOMIC ASSUMPTIONS 1/	-104.5	-98.8	-104.7	-103.7

1/ NOTE: OMB ESTIMATES FOR ECONOMIC ASSUMPTION DIFFERENCES ONLY. DOES NOT REFLECT DIFFERENCES IN TECHNICAL ESTIMATES.

VI. THE PRESIDENT'S FY 83 BUDGET SAVINGS PROGRAMS

- IN AN EFFORT TO MEET HEAD-ON THIS DETERIORATION OF THE FISCAL SITUATION, THE PRESIDENT'S FY 83 BUDGET PROPOSES A BALANCED, COMPREHENSIVE AND SUBSTANTIAL PROGRAM TO CLOSE THE UNANTICIPATED BUDGET GAP. THE BUDGET SAVINGS PROGRAM:

  - REDUCES THE FY 83 DEFICIT BY $56 BILLION -- WITH ANNUAL SAVINGS RISING TO $99 BILLION BY FY 85.

  - REDUCES THE OVERALL CURRENT SERVICES DEFICIT BY $239 BILLION OR 50% OVER THE FY 83-85 PERIOD.

  - ENSURES THAT THE DEFICIT WILL DECLINE STEADILY FROM THE FY 82 RECESSION PEAK, AND THAT DEFICITS DURING THE RECOVERY PERIOD FY 83-85 WILL NOT EXCEED HISTORIC LEVELS RELATIVE TO GNP OR TO TOTAL CREDIT AND CAPITAL AVAILABILITY.

FIVE-PART BUDGET SAVINGS PLAN
— FY '83-85 —
(BILLIONS OF DOLLARS)

	FY '83	FY '84	FY '85	TOTAL	SHARE
ENTITLEMENT REFORMS	11.7	17.1	22.8	51.6	22%
USER FEES	2.5	3.5	3.8	9.8	4%
DISCRETIONARY PROGRAM CUTS	14.2	26.1	35.3	75.6	32%
MANAGEMENT INITIATIVES	20.3	24.0	23.9	68.2	28%
TAX REVISIONS	7.2	13.5	13.5	34.1	14%
TOTAL	55.9	84.1	99.3	239.3	100%

KEY ENTITLEMENT REFORMS

MEDICAL CARE

- o PROVIDER REIMBURSEMENT SAVINGS
- o CO-PAYMENTS AND INDEXING OF DEDUCTIBLE
- o FEDERAL EMPLOYEE COVERAGE -- HI TAX
- o PRO-COMPETITION COST CONTAINMENT PLAN -- LATER TRANSMITTAL

CASH ASSISTANCE

- o SSI -- MEDICAL DISABILITY AND 24 MONTH PROGNOSIS
- o AFDC -- TIGHTEN WORKFARE, BROADEN INCOME TESTS

FEDERAL RETIREMENT

- o LOWER OF FEDERAL PAY RAISE OR CPI
- o LIMIT COLA TO LESS THAN CPI WHERE ANNUITIES EXCEED CURRENT RETIREMENT LEVELS

KEY ENTITLEMENT REFORMS
(CONTINUED)

FOOD STAMPS AND NUTRITION

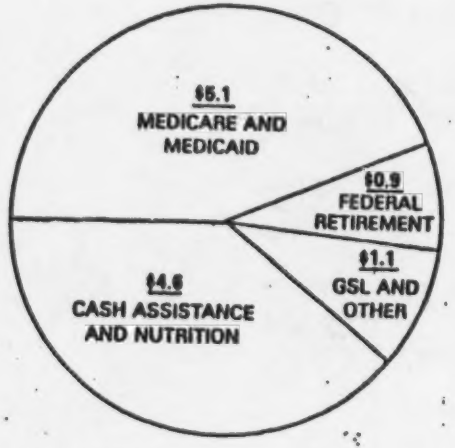
- RAISE INCOME CONTRIBUTION FOR FOOD FROM 30% TO 35%
- ELIMINATE EARNED INCOME DISREGARD
- BENEFIT ROUNDING, MANDATORY JOB SEARCH
- ELIMINATE SPECIAL MILK AND SUMMER FEEDING

GUARANTEED STUDENT LOANS

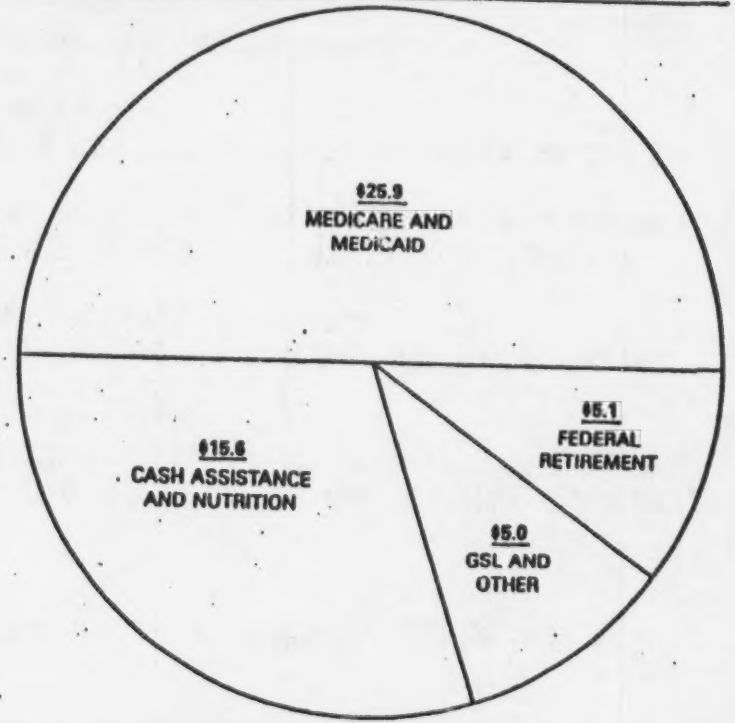
- RAISE ORIGINATION FEE FROM 5% TO 10%
- TIGHTEN AND APPLY NEEDS TEST TO ALL APPLICANTS
- ELIMINATE FULL INTEREST SUBSIDY FOR GRADUATE STUDENTS

ENTITLEMENT REFORMS

(BILLIONS OF DOLLARS)



FY '83: $11.7



FY '83-85: $51.6

USER FEE INITIATIVE

FIFTEEN NEW, INCREASED OR RE-PROPOSED USER FEES WOULD YIELD $2.5 BILLION IN FY 83 RISING TO $3.8 BILLION BY FY 85.

- o AVIATION USER FEES TO RECOVER 85% OF AIR TRAFFIC CONTROL SYSTEM COSTS FINANCED WITH 8% PASSENGER TICKET TAX AND INCREASED GENERAL AVIATION GASOLINE AND JET FUEL TAXES
- o CORPS OF ENGINEERS NAVIGATION FEES TO RECOVER NEW CONSTRUCTION AND MAINTENANCE EXPENSES FOR COMMERCIAL PROJECTS
- o COMMERCIAL NUCLEAR WASTE DISPOSAL TO ESTABLISH AN INDEPENDENT AND SELF-FINANCING WASTE DISPOSAL OPERATION -- $300 MILLION IN INITIAL YEAR
- o COAST GUARD USER FEES FOR LICENSES, INSPECTIONS, NAVIGATION AIDS AND SEARCH AND RESCUE MISSIONS
- o RECREATION FEES FOR PARK ENTRY AND USE OF FACILITIES
- o PATENTS AND TRADEMARK FEES TO COVER APPLICATION PROCESSING COSTS AND TO OFFSET THE COSTS OF PATENT AND TRADEMARK OFFICE (PTO).

USER FEES

(MILLIONS OF DOLLARS)

FY '83: $2,487

FY '83–'85: $9,776

HIGHLIGHTS OF DISCRETIONARY PROGRAM SAVINGS

EDUCATION, EMPLOYMENT AND TRAINING

- CONSOLIDATION OF EMPLOYMENT AND TRAINING PROGRAMS INTO BLOCK GRANT -- $1.9 BILLION SAVINGS
- TARGET PELL GRANTS TO LOWER INCOME STUDENTS
- REDUCE CAMPUS BASED AID PROGRAMS -- FOCUSE ON WORK-STUDY
- IMPACT AID -- LIMIT PAYMENTS TO "A" STUDENTS ONLY
- ELEMENTARY AND SECONDARY EDUCATION -- REDUCE GRANTS BY $1.8 BILLION
- VOCATIONAL EDUCATION AND REHABILITATION -- REDUCE GRANTS BY ONE-THIRD

HOUSING

- ELIMINATE NEW SECTION 8 STARTS EXCEPT FOR 10,000 ELDERLY UNITS AND REPLACE WITH LESS EXPENSIVE CERTIFICATES -- 107,000 IN FY 83
- 30% RENT BURDEN FOR NEW TENANTS; COUNT FOOD STAMP INCOME, ELIMINATE NEGATIVE RENT PAYMENT

HIGHLIGHTS OF DISCRETIONARY PROGRAM SAVINGS

(CONTINUED)

INCOME SECURITY, SOCIAL SERVICES

- o CONSOLIDATE WIC WITH MCH
- o RE-TARGET LOW-INCOME ENERGY AID TO COLDER STATES
- o REDUCE TITLE XX GRANTS BY 18%
- o CHILD WELFARE BLOCK GRANT
- o NO FUNDING FOR LEGAL SERVICES

TRANSPORTATION

- o REDUCE FUNDING FOR NON-INTERSTATE HIGHWAYS BY 21%
- o REDUCE MASS TRANSIT OPERATING SUBSIDIES BY 38%
- o REDUCE AMTRAK BY $185 MILLION -- INCREASED COST ABSORPTION BY LABOR, PASSENGERS, LOCALITIES

HIGHLIGHTS OF DISCRETIONARY PROGRAM SAVINGS

(CONTINUED)

ENERGY AND NATURAL RESOURCES

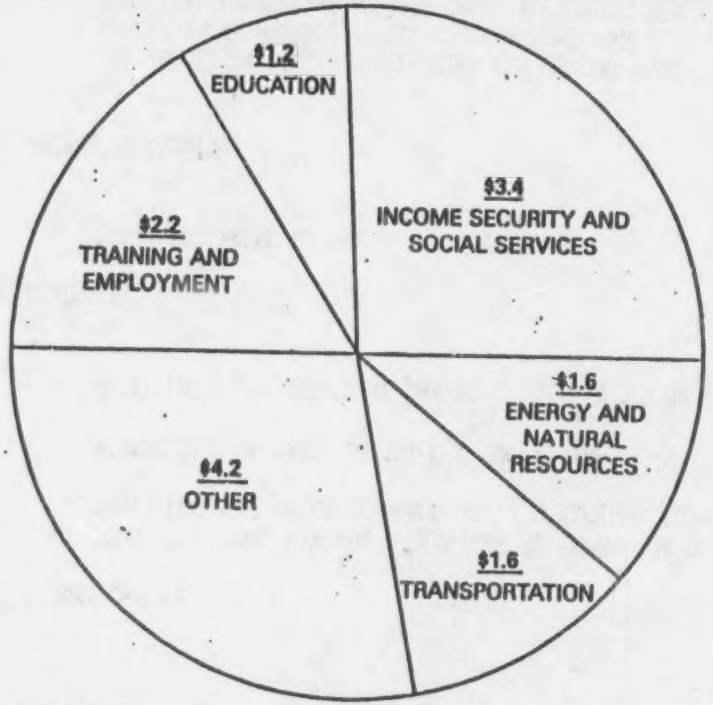
- ELIMINATE REMAINING NON-NUCLEAR DEVELOPMENT, DEMONSTRATION AND COMMERCIALIZATION FUNDING -- SAVE $900 MILLION
- TERMINATE STATE CONSERVATION AND LOW-INCOME WEATHERIZATION
- CUT SOIL CONSERVATION GRANTS 33%

BUSINESS SUBSIDIES

- EXPORT-IMPORT BANK DIRECT LOANS 18% BELOW CURRENT SERVICES
- NO NEW MARITIME CONSTRUCTION OR OPERATING SUBSIDY CONTRACTS

DISCRETIONARY PROGRAMS

(BILLIONS OF DOLLARS)



TOTAL: $14.2

MANAGEMENT INTIATIVES

IRS COLLECTION AND ENFORCEMENT

- 5200 ADDITIONAL IRS STAFF TO REDUCE DELINQUENT ACCOUNT BACKLOG, INCREASE AUDIT COVERAGE OF LARGE COMPANIES, AND IDENTIFY NON-FILERS
- WITHHOLDING OF TAXES ON INTEREST AND DIVIDENDS
- ACCELERATION OF CORPORATE TAX COLLECTION TO 90% OF ESTIMATED LIABILITY

FEDERAL PAY RESTRAINT

- LIMIT PAY RAISE TO 5%

ACCELERATED OFF-SHORE LEASING

- THE ADMINISTRATION'S ACCELERATED OCS LEASING PROGRAM IS EXPECTED TO RESULT IN AN AVERAGE OF 5.7 MILLION ACRES PER YEAR IN SALES, WHICH IS MORE THAN DOUBLE THE AVERAGE UNDER THE CARTER SCHEDULE
- WILL RESULT IN INCREASED BONUS PAYMENTS THAT NEARLY DOUBLE PROJECTED RECEIPTS FROM OCS BONUS AND ROYALTY PAYMENTS TO A TOTAL OF $18 BILLION IN FY 83

MANAGEMENT INITIATIVES
(CONTINUED)

SURPLUS PROPERTY DISPOSAL:

- SURPLUS GSA PROPERTY TRANSFERRED TO OTHER AGENCIES ONLY AT MARKET VALUE, NOT FREE AS CURRENT PRACTICE
- HIGH-LEVEL PROPERTY REVIEW BOARD TO OVERSEE REAL PROPERTY MANAGEMENT, IDENTIFICATION OF UNNEEDED HOLDINGS AND SPEEDY DISPOSAL WHEREVER POSSIBLE
- DISPOSE OF TENS OF MILLIONS OF ACRES OF PUBLIC LAND WITH NO UNIQUE WILDERNESS, RECREATIONAL OR HISTORIC SIGNIFICANCE, INCLUDING PARCELS ADJACENT TO NEWLY URBANIZED AREAS, AND SMALL, ISOLATED TRACTS TOO COSTLY TO MANAGE

DEBT COLLECTION

- 24 AGENCIES WILL HAVE COMPREHENSIVE COLLECTION PLANS AND TARGETS -- INCLUDING INCREASED TRAINING, ACCOUNTABILITY AND IMPROVED TECHNIQUES
- NEW LEGISLATIVE AUTHORITY INCLUDING FURNISHING OF SOCIAL SECURITY NUMBERS, BROADER AUTHORITY TO CONTRACT OUT, POWER TO ASSESS INTEREST AND PENALTIES ON OVERDUE ACCOUNTS AND TO REFER INFORMATION ON DELINQUENT DEBTORS TO CREDIT BUREAUS

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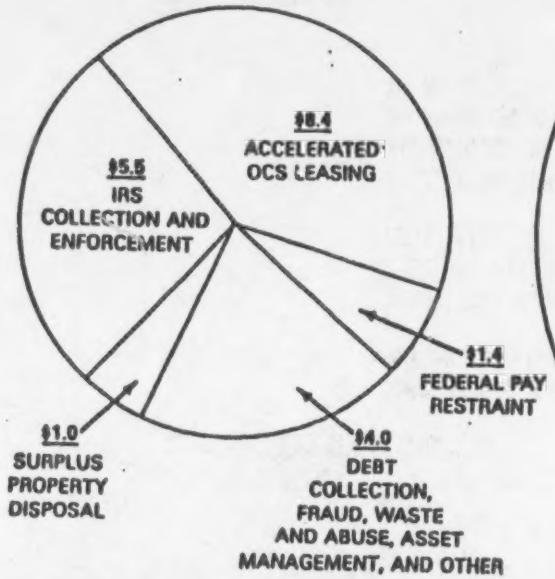
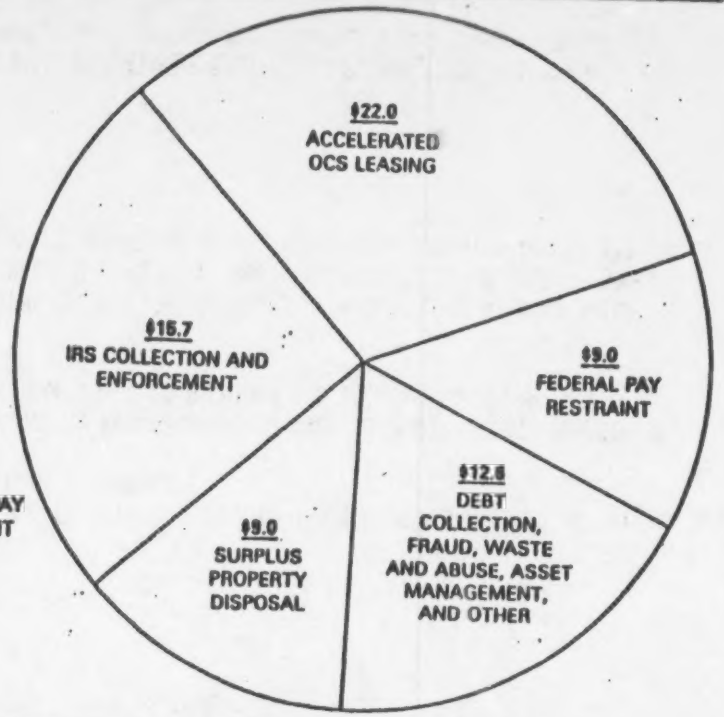
MANAGEMENT INITIATIVES

(BILLIONS OF DOLLARS)



FY '83: $20.3



FY '83-'85: $68.2

TAX REVISIONS

CHANGES ARE DESIGNED TO ELIMINATE ABUSES, REMOVE OBSOLETE INCENTIVES, CORRECT UNINTENDED LOOPHOLES, AND REQUIRE PROFITABLE BUSINESS TO CONTRIBUTE AT LEAST SOME MINIMUM FAIR SHARE.

- o DISALLOW COMPLETED CONTRACT METHOD OF TAX ACCOUNTING. TAXPAYERS WILL BE REQUIRED TO USE EITHER THE PERCENTAGE OF COMPLETION METHOD OR THE PROGRESSIVE PAYMENT METHOD OF ACCOUNTING FOR LONG-TERM CONTRACTS.

- o REPEAL ALL BUSINESS ENERGY TAX SUBSIDIES AND SPECIAL PROVISIONS ALLOWING STATES AND LOCALITIES TO ISSUE TAX-EXEMPT INDUSTRIAL DEVELOPMENT BONDS TO FINANCE CERTAIN ENERGY PROJECTS.

- o ASSETS FINANCED WITH TAX-EXEMPT REVENUE BONDS ISSUED AFTER 1982 MUST BE DEPRECIATED USING THE STRAIGHT LINE METHOD. TAX-EXEMPT REVENUE BOND FINANCING WILL BE LIMITED TO BONDS THAT ARE PUBLICLY APPROVED AND AFTER 1985, RECEIVE A FINANCIAL COMMITMENT FROM THE LOCAL GOVERNMENT. SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS WILL NOT BE ALLOWED FOR LARGE BUSINESSES.

TAX REVISIONS
(CONTINUED)

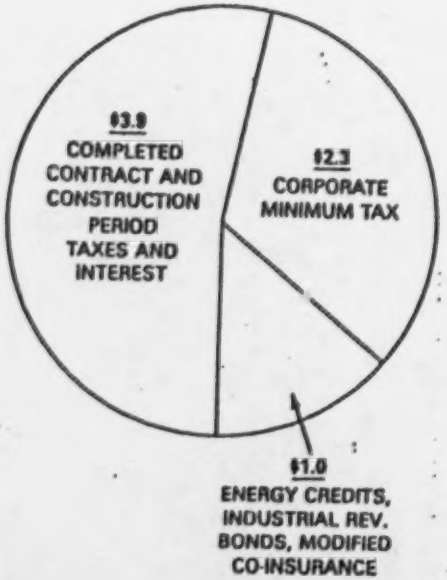
- REPEAL UNINTENDED WINDFALL FROM MODIFIED CO-INSURANCE TAX ACCOUNTING ROLES.

- AMORTIZE CONSTRUCTION PERIOD INTEREST AND TAXES INCURRED BY CORPORATIONS TO DEVELOP NON-RESIDENTIAL REAL PROPERTY. COSTS WILL BE RECOVERED OVER TEN YEARS.

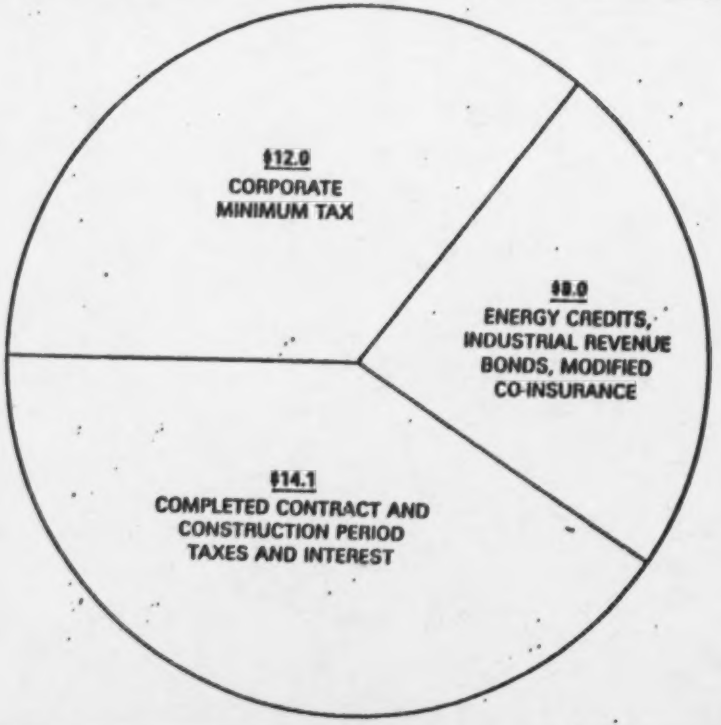
- TO THE ADD-ON MINIMUM TAX WILL BE REPLACED WITH A 15% ALTERNATIVE MINIMUM TAX THAT WOULD APPLY ONLY TO THOSE CORPORATIONS THAT PAY VERY LOW REGULAR TAX RATES.

TAX REVISIONS

(BILLIONS OF DOLLARS)



FY '83: $7.2



FY '83-'85: $34.1

Chairman ROSTENKOWSKI. Thank you, Mr. Stockman.

I want to remind you that we did present an alternative last year. It was developed in this committee with the participation of both sides, Democrat as well as Republican.

You refer to the $90 billion deficit in the President's budget. You, of course, are anticipating the fact that we will raise taxes by approximately $13 billion in fiscal year 1983 and reduce spending by approximately $43 billion.

In this committee last year, it was suggested that we reduce spending programs by $9.4 billion with respect to programs within the jurisdiction of this committee. That effort was accomplished by the bipartisan cooperation of all Members of the committee.

In the President's new budget he requests a further reduction of $5 billion with respect to spending programs within the jurisdiction of the Committee on Ways and Means.

I noted in several television performances yesterday and in some of the articles that I have read that there will be an opportunity for Congress to participate in developing a budget, if we present a comprehensive program.

It disturbs me that the President has suggested that the defense budget is untouchable; that the tax cuts enacted last year are off limits and that we can only focus the deficit reduction effort on programs that have been initiated by Congresses over the last 20 years.

What the President is really asking is that the burden of reducing the deficit be shouldered by people that have the smallest shoulders, people that are receiving benefits from the Federal Government.

As I said in my opening statement, I am certainly one who wants to cooperate with this administration. I do not think there is a Member here who does not have ideas as to how to cut spending or raise taxes. But the mix, naturally, is not one that is articulated with one voice.

We are not the administration. We did not win last year.

I would like your views as to why the defense budget is an area that is off limits. In some conversations that I have had with members of the administration, it has been suggested that there will be a different view of the President's budget when Members come back from their districts after the district work period. There will be a different view, Mr. Stockman, in my opinion.

The view will be that the defense budget is not a sacred cow. Mayors, such as my friend Dick Fulton from Nashville, who is a former member of our committee—can no longer suffer the cuts in their budgets. Governors, with whom you have been discussing this budget, are certainly not enchanted with the thought of the New Federalism. Why is it that the President feels that defense spending cannot be touched? How much of an olive branch is being extended to Congress when the defense budget is shielded from bearing its fair share of the budget cuts? Why should we reduce the deficits on the shoulders of poor people; but defense is untouchable?

Mr. STOCKMAN. Mr. Chairman, let me try to respond in two ways:

One, on the matter of the defense budget per se, I think you have to recognize that we have a little history to contend with here. During the mid and late 1970's defense was drastically underfunded. As a result, we confronted a situation in 1981—even before this administration came to office—in which the Congress agreed that substantial increases in pay were necessary; that substantial increases in readiness funding were necessary; that we had fallen drastically behind in investment on strategic weapons and the credibility of our strategic deterrent; and that substantial investments in modernization of our rapid deployment capability and of our conventional forces would be necessary.

So we are playing catch up in a sense for the neglect and underfunding that occurred for more than a decade.

As you look at that large number, it is an inviting target. The number for outlays is $216 billion in 1983. As you begin to peel down that number you see that about $50 billion of it is for pay—and that is needed if we are to continue to have success in recruiting capable people and retaining the skill mixes and so forth we need—and it will be difficult to do much about that.

If you look at operations and maintenance—the basic investment in day-to-day operations of our armed services required to reduce maintenance backlogs and to increase spare parts, for instance, so that our attack air capabilities are combat or mission ready—you will find that $135 billion of that big number is composed of pay and those kinds of day-to-day necessary operational spending.

There may well be great debate in this Congress and differences of opinion about the strategic initiatives of this administration or about some of the investments in the recovery of our naval force capability or of our tactical air capabilities, but I would offer this caveat: that even if changes are made in the investment levels in those areas, the impact on outlays will be very small during this budget and the next budget, and it simply cannot be solved there.

Let me give you a good example. We have two carriers in this budget, $7 billion in total obligational authority. It will take 8 years to build those carriers, and if you decide to knock one of them out this year, you will cut the budget by $3 billion in TOA, by about $25 million in outlays, and you will reduce costs by about $750 million over the next 7 years.

Similarly, if you take all of the large weapons systems in this budget—$49 billion worth of systems that will cost this year more than half a billion dollars—if you took them all out—and that would obviously have terrible adverse effects on our military capabilities—you would only save $6 billion.

That might take a little bit out of the deficit, but at great, great cost in the future.

My first point, Mr. Chairman, is, I don't think as you examine the details—not the big number, but the details—and you put those details in the context of the past trends that clearly were inadequate, you will find it very difficult to find savings and reductions in the defense budget of a large magnitude that can somehow solve this deficit problem in one fell swoop.

The other point I would make is that I cannot accept your characterization that the spending cuts that we have proposed fall on the smallest shoulders. I would point out that of the $56 billion in

deficit reduction measures, $20 billion are due to management initiatives, which involve increased offshore leasing—that comes from oil companies—increased debt collection—that comes from a whole variety of business and commercial interests who have not paid their debts to the Federal Government—increased revenue collection activities at the IRS for delinquent tax payments that are due, and the sale of Federal properties that are in surplus or excess and could be better transferred to the private sector.

Those aren't small shoulders. Those are part of the mainstream of our economy.

Another $7 billion is due to the tax revisions and loophole closing measures. Again that will fall primarily on business in terms of the corporate minimum tax and on tax incentives that are no longer needed.

That is half, Mr. Chairman, of the $56 billion in those two areas, totally outside what you have described as the small shoulders.

If you take even the proposals before this committee, the medicare-medicaid savings of somewhere in the range of $5 billion, 88 percent of the medicare savings are savings that will result from tightening or revising reimbursement provisions in terms of providers, hospitals, long-term care, physicians, and so forth.

While some may make the argument that some of these savings will be passed on to beneficiaries, I think if you look at these measures carefully, you will see that those savings can be made without any direct impact in the main on beneficiaries.

I could go on down the line and point out that other entitlement savings outside of this committee, to the tune of over $1 billion a year, come out of the Federal civilian and military retirees and so forth.

Again those savings aren't falling on small shoulders. There is concern about some of the cuts, I am sure, in food stamps, and some domestic social welfare programs. Those need to be debated.

I think they can be defended. I will do my best to provide the strongest defense possible; but do not characterize this whole budget or the whole deficit savings plan as something that falls on social programs or small shoulders because I don't think the facts really warrant that.

Chairman ROSTENKOWSKI. Mr. Stockman, the President is asking the American people to share a greater proportion of the burden with respect to spending cuts. That is all I have been hearing from Governors and mayors with respect to programs that have already been reduced. As far as further spending cuts, I do not think the President's proposals will fall on favorable ears in Congress.

I think that will be true not just in the House of Representatives but in the Senate as well.

Let me conclude with this comment, Mr. Stockman:

In my opinion, there comes a time in every administration where the President has surrounded himself with people that are continuously nodding their heads in the vertical direction. As a former member of this body and as an astute member of the administration, I just hope that when you feel you are right and others are wrong, you will have the courage to stand up and counsel the President because there is a great deal of admiration here in the Congress for your knowledge and ability. I just hope in the future

that you will feel free to admonish this administration when it is wrong and come to the Congress and give us the benefit of your thinking.

Mr. Pickle will inquire.

Mr. PICKLE. Thank you, Mr. Chairman.

Last week one of the people testifying before this committee made reference to the fact that the recession we have now is Dave Stockman's recession.

Do you think this is the Dave Stockman recession?

Mr. STOCKMAN. Mr. Pickle, to my knowledge a recession has not been blamed on a single individual since President Herbert Hoover in 1932. I don't think I would care to join that company, nor qualify, because this recession is the result of forces and imbalances that have built up in the economy over a long period of time.

It is a result of short-run monetary factors that really couldn't have been anticipated and that could have perhaps been prevented.

I think there is enough blame to go around for a lot of people over a long period of time.

Therefore, I would decline the suggestion.

Mr. PICKLE. I can appreciate that. There are many of us who would agree with you that this is not Dave Stockman's recession.

Would you care to say whose recession it is?

Mr. STOCKMAN. I don't think that would be helpful, Mr. Pickle. I think now that we are in it, we have to figure out how to contend with it rather than decide whose it is.

Mr. PICKLE. Here is what concerns me. In line with the Chairman's questioning, we are all concerned about why the interest rates continue to be high and are going up. One school of thought seems to say there is a basic conflict between the monetary policy of the Federal Reserve and the policy of the administration, the tax and spending policy. We have huge deficits.

We have to make some reduction. I assume when they say this is Stockman's recession, they say it because you are concerned about the deficit. You have been trying to do something about it.

You and the administration last year were willing to take the 5-10-10 approach. If we are going to make some major changes, we have to make choices.

The Chairman asked if you would consider some reductions in defense. You gave us a history lesson about how much we need to re-arm. That is true.

The question I want to ask you is, do you think it is reasonable to assume the Congress could make some adjustments in defense spending and still maintain our safety?

Mr. STOCKMAN. Mr. Pickle, as I indicated before, we do not believe that any significant change in the defense request for this year is desirable and that if such a change is made, it would have serious repercussions on our foreign policy and security objectives.

Whether Congress will do something, I would leave that to this committee and others to forecast.

I recognize that Congress may have different ideas and may come up with different approaches. We would have to look at those carefully at the time that they emerge.

Mr. PICKLE. Your testimony then would be the same with respect to change of tax policy—that is, the deferment of the third year tax

cut. You don't want to make any change in tax policy over and above the revenue raisers and the management initiatives that you have recommended in your budget?

Mr. STOCKMAN. Mr. Chairman, that is precisely right. The President has indicated very clearly no fundamental retreat on the business and individual reductions, but has identified areas of the code that can be corrected and would raise revenues.

Mr. PICKLE. If you would not take any change in defense, if you do not make any change in tax policy, the only option left is to make the savings in the discretionary funds; primarily cut domestic spending.

You cannot make up this $91 to $100 billion deficit by just cutting the domestic spending solely. Some of the things you recommended in savings may be achievable, but a lot of that is just pie in the sky.

You are not going to get it because you already have opposition to a lot of the things that are recommended. If we don't make changes in defense at all or in the deferments, the only alternative left is the discretionary funds.

Where would you cut them? Is that too broad a question to ask you? That is the only alternative we have left.

Mr. STOCKMAN. Mr. Pickle, I think your question does not track with the whole range of measures that we have proposed. These aren't purely discretionary programs, but some innovative efforts on the part of the administration to reduce the deficit outside of discretionary programs per se.

If you take the $56 billion in deficit reductions we have proposed for 1983, only $14 billion comes from discretionary programs. The remainder, most of it, comes from user fees, the whole array of management initiatives, some nonsocial security entitlement reforms that I think are well justified, and increases in revenues resulting from these changes in the code.

That was the preponderant share of it. Maybe the Congress will have other ideas, but I would suggest to you there are more places to look than simply discretionary annual appropriated programs.

Mr. PICKLE. Well, the Congress will look at them, but we must also look at the areas we have just mentioned. I think we must work together on a bipartisan basis. I think that is extremely important. I also hope you would be honest in the sense that you just said that your estimates on the GNP real growth were overestimated 50 to 65 percent since last February. That is an honest admission.

Mr. STOCKMAN. Mr. Pickle, I said every estimate was off by that much; CBO, ourselves.

Mr. PICKLE. The estimates were off, yet 2 weeks ago the President came in, submitted to the Congress his estimate of the projections, and it shows we are going to have a 0.2 GNP growth in 1982 and then in 1983 it is going to shoot up to a plus 5.2.

Do you think that is realistic now?

Mr. STOCKMAN. Yes, I do, Mr. Pickle. That is 1983.

Mr. PICKLE. I understand that.

Mr. STOCKMAN. It is about six or seven quarters away. That growth rate is below the real growth rate you have had in the first

six quarters after recovery in every recession we have had in the last two and a half decades.

It is less than the growth rate we had in 1975–76, less than 1970, less than 1958, 1957, and so forth. So for the immediate period of a recovery, after you come from a slump in business activity, that real growth rate is by no means unprecedented.

If we can reduce the deficit and thereby insure that there is not a collision in the marketplace between private credit demands and government demands, then we can be confident of that number.

If we can't, then I think we would be concerned about that number.

Chairman ROSTENKOWSKI. Mr. Duncan will inquire.

Mr. DUNCAN. Thank you, Mr. Chairman.

Mr. Stockman, most reports indicate that the mayors and Governors support the concept of the new federalism, but they also have problems with timing details.

How would you respond to their concerns?

Mr. STOCKMAN. Mr. Duncan, I think the answer there is that we have provided a 2-year period before it would be effective. We also have provided a 4-year transition so there would not be any abrupt discontinuity or shock. But most importantly, we have offered only a framework and have offered to sit down and discuss and negotiate with the Governors, the State legislators, the mayors, and the counties, before we present a legislative proposal to Congress. Some of the concerns they have therefore would be reflected in the final plan proposed.

I believe we are being responsive to the concerns that they have conveyed to you.

Mr. DUNCAN. When do you think you would anticipate they could take over these programs?

Mr. STOCKMAN. The proposal now—of course, this is subject to change—the proposal now is that during the period 1984, fiscal years 1984 through 1987, they would have a voluntary option to take over, but, if they felt they weren't ready, they could continue to participate in Federal categorical programs for highways or vocational education or whatever.

The mandatory takeover would not occur until fiscal year 1988, which is 5 years away and ought to provide ample time for them to gear up to take over these responsibilities.

We have also indicated that if a longer transition period is needed before the mandatory takeover, we would be responsive to that concern if it were well justified and demonstrated.

Mr. DUNCAN. At the present time many States would not be equipped or able to take over a lot of the programs, is that correct?

Mr. STOCKMAN. That is correct. Under the plan we proposed, they wouldn't have to until 1988.

Mr. DUNCAN. Would you anticipate we would make sure that they could take over the programs or were able to take over the programs before we gave up other programs that at the present time the Federal Government is controlling?

Mr. STOCKMAN. I am not quite sure of the import of your question. I don't believe that we would want to do anything other than require the State to make a decision through the State legislature and the Governor to withdraw from the Federal program.

I don't think we should give them a test. I don't think we should give them a fitness test because, if we give them a fitness test, we are simply back into the same system we have today.

Mr. DUNCAN. Thank you very much, Mr. Stockman.

Chairman ROSTENKOWSKI. Mr. Stark will inquire.

Mr. STARK. Welcome to the committee.

I was a little concerned over the weekend, reading in the press that there is a suggestion that the administration might want to slow down.

Last year, we were not stampeded but we were certainly hurried along in the budget process. As a matter of fact, we barely participated in it other than to vote "yes" or "no." Now, I understand the strategy has changed and perhaps it will be easier to get the budget if we drag it out until maybe September, when everybody is anxious to get home and get reelected.

If there is any feeling we might want to go a little slower in grinding out the budget, we run out of money.

Do you think it is important for us to know how big the deficit is going to be before we start raising the debt limit?

Mr. STOCKMAN. That is a good question.

However, I believe your action would primarily relate to fiscal year 1982. Most of the action pending before the Congress is fiscal year 1983 and beyond, so I believe at the time that that issue must be addressed——

Mr. STARK. We should raise it for current needs?

Mr. STOCKMAN. Under our current procedure, the 1983 debt ceiling needed is driven by the budget resolution adopted for 1983 and, of course, that will be later in the year and could be addressed in the context of what the Congress decides to do about the size of the deficit. This current ceiling is only for 1982.

Mr. STARK. You are not worried about waiting until later in the year to get a budget resolution?

Mr. STOCKMAN. Yes, I am. I don't think that there is any conscious strategy at the White House, unless you believe everything you read in the New York Times, to say that we should wait until September to get a budget resolution.

That is impossible to get savings in fiscal 1983.

Mr. STARK. Let me ask you how you would answer a constituent of mine. This happens to be a Rotary Club meeting, and a man stood up. He is a service station owner and operator, and a salesman was trying to sell him an engine testing analyzer, kind of tuneup machine, and it would have cost him $10,000 down, and he would have borrowed the difference from the Bank of America, and as he figures out, by the time he hired someone to run it and if he sold as many tuneups and spark plugs and whatever else you sell as a result of this, that on his $10,000 down, he would probably make another $100 a month.

He said, "I am making more than that leaving my money in money market funds, so why should I invest?" I think he probably had a good question. Why should he invest?

What is your program going to do to encourage this person to invest and perhaps increase employment far more drastically than the marginal increases of big companies?

Mr. STOCKMAN. In the very short run, you are right. The aversion in the yield curve is so bad that there is a strong temptation to keep funds deposited.

Mr. STARK. I understand the yield curve.

Mr. STOCKMAN. I believe there is a good prospect that the short rates in the money markets will be coming down. The money market eased substantially Friday.

Mr. STARK. In 4 or 5 years.

Mr. STOCKMAN. Two points. His problem is, one, the current choice he has between the long-term capital investment; the money market investment; that choice will be less attractive, we believe, in a very short period of time.

Second, if you describe the equipment correctly as I understand it, it sounds to me that it would be eligible under ACRS for a 5-year writeoff, plus the investment tax credit, and as the leasing business matures, he would be able to sell and get the tax benefit.

Mr. STARK. I brought that up to him and he does not pay enough taxes, or make that kind of money to make that attractive.

However, if you include him and people who are laid off from work and are unable to take advantage of these new tax deductions, would you support a kind of safe harbor leasing provision for individuals so this service station operator and the poor people in my district who don't have any taxes to pay, could sell their deductions and tax credits to wealthier people?

Mr. STOCKMAN. The Secretary of the Treasury will be here this afternoon.

Mr. STARK. Would you support that?

Mr. STOCKMAN. I think it is a rather vague proposal.

Mr. STARK. Sauce for the goose is sauce for the gander.

Mr. STOCKMAN. I would disagree with that, and I think the Secretary will give you a fuller explanation this afternoon, but if you will permit me, the leasing provisions——

Mr. STARK. Before you answer that, let me ask you about student loans for a minute.

Mr. STOCKMAN [continuing]. Can I answer the pending question first?

Mr. STARK. Let me ask you this, first.

Did you have a student loan?

Mr. STOCKMAN. I didn't have a Government student loan.

Mr. STARK. Would your parents have qualified, would you have been exempted under the means test that you now propose?

Mr. STOCKMAN. I probably would have qualified.

Mr. STARK. You figure now we should disqualify a lot of kids just because they are adults, and they are over 18 legally, but because their parents may have more income or less, that that should disqualify them?

Mr. STOCKMAN. The whole point is——

Mr. STARK. The service station operator and the poor people don't have these safe harbor provisions.

Mr. STOCKMAN [continuing]. What I suggested was that the lower income student you are talking about should be qualified for Pell grants and guaranteed student loans, that those from higher income families shouldn't be.

Mr. STARK. After they are 18, they are not from the family. They are legal citizens. Why should you blame somebody for being successful parents?

Mr. STOCKMAN. It has been a standard practice for a long time to consider parental resources in the determination of aid in a whole variety of programs.

Mr. STARK. For children. But for adults we changed the definition from 21 to 18.

Mr. STOCKMAN. We simply can't afford, nor should we, to provide a guaranteed interest subsidy to all students 18 and above who are in universities and other institutions of higher education today.

Mr. STARK. How much does that cost us a year?

Mr. STOCKMAN. A horrendous amount of money, $3.5 billion just to pay the interest subsidy on the $28 billion that we have outstanding.

Mr. STARK. How much does safe harbor leasing cost us?

Chairman ROSTENKOWSKI. The time of the gentleman has expired.

Mr. Jenkins will inquire.

Mr. JENKINS. Mr. Stockman, you indicated in your statement that you did not foresee the tightening of monetary policy last year. What do you mean, you didn't foresee it? Chairman Volcker has always been rather firm and adamant in that position.

Mr. STOCKMAN. I had a very precise and limited meaning. We didn't expect that there would be the severe temporary tightening from about May to October—the growth rate was zero or below for most of that period.

During 1981, the growth of the money supply was reduced and lower than it had been in the previous year, but this abrupt period of no growth was not anticipated, and that clearly had a repercussion on the economy, and it clearly was one of many factors contributing to the recession.

I am not blaming the Federal Reserve, it couldn't necessarily have averted or avoided. Nevertheless, it was one of those unforeseen and unexpected developments last year that has changed the course of the economy, contributed to the recession, and changed the budget outlook.

Mr. JENKINS. Are you saying that the Federal Reserve should not have done that?

Mr. STOCKMAN. We would all be better off today if there could have been a smoother descent, a steady reduction of the money supply growth rate over 2 or 3 years rather than the kind of sudden jolt we had last summer. I recognize that it is very difficult for them to avoid episodes of that sort and am not necessarily criticizing them, simply citing the fact that we now have to accept it as history and as part of the force that is creating our current budgetary dilemmas.

Mr. JENKINS. You may not be criticizing them, but I don't believe I detect any award presentations from what you are saying. You are really saying the abrupt action on the part of the Federal Reserve contributed significantly to the high interest rates and the recession, are you not?

Mr. STOCKMAN. What I am saying is two things: One, last year the Fed did hit on a year-over-year basis their money supply target.

That is to be applauded. Inflation is coming down dramatically and substantially as a result. That is the most important thing.

Second, in terms of short-term timing, it might well have been more desirable to have a smoother descent last summer and avoid the ups and downs we had from spring to summer and fall. They are working on correcting and avoiding a repeat. It contributed to the short-run condition of the economy, but we have to accept what has happened and move forward from there.

Mr. JENKINS. Let me go on to the matter of the economic feedback from the tax cut that was enacted last year. I met with you on two occasions last year, and with Secretary Regan, and I have never heard such optimistic figures about what feedback we were going to have.

Taking your March 1981 estimate of the deficit for fiscal 1983, are you saying that you were off by roughly $100 billion?

Mr. STOCKMAN. $89 billion, from $2½ billion to $91½ billion.

Mr. JENKINS. Then you were off roughly $91 billion in 1984 and, under your best estimates, $93 billion in fiscal 1985.

Now, what I want to know is where is the feedback? If we are anticipating under the most optimistic set of circumstances that we will be off in our estimates by roughly $100 billion in each of those 3 years, when does the feedback begin? When does the program start working?

Next Thursday, at 2, or in 1986, or is it working now?

Mr. STOCKMAN. Mr. Jenkins, I think I am making a rather different point there. What I am saying is that our current budget projections for those years differ from those made last year by the magnitude of the numbers you have just cited. I also have indicated that the reason for the difference is a recession that no one anticipated; interest rates that have remained higher longer than seemed possible in historical experience, where you never had a very large differential between the inflation rate; and the interest rate and the fact that inflation has come down much more dramatically than even we predicted last year, and we were accused of being rosy as a result.

You see other forecasters were off by similar, perhaps not as large, but similar magnitudes.

Mr. JENKINS. That is like me voting for some bill that is unpopular and trying to say, "Well, everybody else voted for it, too." My people don't buy that. Just because you may be wrong, I don't think you can say, "So were a lot of other people."

I can't conceive of being off $100 billion a year in estimates on the deficit when we have passed the program, you and the administration asked for. That really disturbs me: that one recession would so upset the entire forecast, and that is really what we are seeing.

Mr. STOCKMAN. I am saying that it is one recession, and the reduction in inflation. If you look at the economic assumptions table I provided in my testimony, you will see that GNP is $176 billion lower for 1983 and $215 billion lower figure for 1985. These are large order of magnitude changes that have an enormous effect on budget receipts.

In an economy that is $3.5 trillion $176 billion doesn't sound like very much. In terms of its impact on the budget, and the estimate of receipts, however, it is obviously large and creates the changes

that you have talked about. I don't think anybody would have forecasted that much lower amount of GNP for 1983 and 1985 a year ago. No one did.

Mr. JENKINS. Doesn't it give one cause for second thoughts about the extent of a $750 billion tax cut, regardless of who proposed it, if in fact we are going to have to live with these deficits? Taking the worst scenario, it is beyond comprehension what you are predicting for the next 4 years.

How can we ever hope to recover economically with that type of forecast?

Mr. STOCKMAN. Well, I think your basic point is right. You simply cannot tolerate or contemplate deficits of the magnitude that would occur if nothing is done by the administration and this Congress.

You may propose other ways of addressing that same problem, but I think the most critical thing is that it be addressed, and that those automatic deficits be substantially reduced and put on a downward path. That is what the whole budget process is about this year, how you get there and what types of initiatives are required.

Chairman ROSTENKOWSKI. Mr. Frenzel will inquire.

Mr. FRENZEL. Thank you, Mr. Chairman.

We are very pleased to have you here, and appreciate the testimony you are giving us today.

I recall the charge given to us by our Chief Executive which is to put up or shut up, and those of us who look at the $82 billion deficit with some horror realize that we need some kind of alternatives if we are going to do any better at whittling down that deficit, and so temporarily, most folks like me, I guess, are shutting up, but it does not mean that we are not casting about for the alternatives that may help us bring that down.

The part of your testimony that impresses me, however, is that we first have to whack away $56 billion in the categories that you mentioned before we can even think about doing better than a $92 billion deficit, and may I ask you about the cuts that you suggested in the entitlements and discretionary spending of some $26 billion roughly, that should come as no surprise to us, we knew we were going to have to make those cuts last year when we adopted the budget, is that correct?

Mr. STOCKMAN. That is correct. Last year we indicated in our budget presentation and also in the first resolution, that additional savings of $30 billion in 1983 and $44 billion in 1984 would be required.

Our budget this year actually provides more than that on the outlay side, but it is consistent with what we clearly indicated and explicitly demonstrated would be needed as part of the implementation of this program last year.

Mr. FRENZEL. When I detected some reduced enthusiasm for reductions in spending, it really would represent a change of policy for Congress if it reneged at least on the beginning promise that it made with the adoption of last year's budget?

Mr. STOCKMAN. That would be correct. At least half of the saving measures we proposed for 1983 and 1984 were approved as policy by the Congress in the budget resolutions last year.

Mr. FRENZEL. You have in your calculation $7.2 billion in new taxes, user charge of $2.5 billion, and what you call management initiatives, there is another $5.5 billion, part of which I call new taxes, and some of it is apparently collection of amounts that may be being evaded now or mistakenly not being paid.

There is a request for more IRS agents to pick up the extra money. I notice that there is another section, in addition to the IRS agents who are supposed to get more money, you have a debt collection item of $4 billion.

Are those two items different?

Mr. STOCKMAN. Yes, those items are different. In the budget we assume some increase in receipts from overdue IRS accounts. In addition, for 1983, there is $1 billion in the allowance function for additional debt collections that we would seek if we get the legislation that is pending to increase the effectiveness and the tools that we have available to collect both loans and IRS overdue debts.

Mr. FRENZEL. My understanding is that this committee has held some hearings on that legislation or at least its portion of that legislation which relates principally to cross-matching of fees and social security numbers, and I understand that that legislation is moving very swiftly in the Senate.

Is that the first piece of legislation we have to pass to get the collection program moving?

Mr. STOCKMAN. Yes, those three measures—the redisclosure provisions, the cross-matching provisions, and the mandatory furnishing of social security numbers by loan applicants—are essential if we are going to achieve the debt collection targets that we have established.

We believe at least $500 million of the target that we have established for 1983 requires that legislation if the money is to be realized.

Mr. FRENZEL. Thank you. It seems to me that is the easiest thing we have to do. One of the problems of our budget is interest rates maintaining a high level. The current relationship between interest rates and inflation is screwy by historical standards. Why are those rates staying up when we have begun to maintain a little control over inflation increases?

Mr. STOCKMAN. I don't know that anybody has a satisfactory or completely persuasive or convincing explanation but I can cite a couple of factors. One, the long-term bond market has been closed or in a state of almost nonactivity for over a year. In part that reflects a fear that the current inflation reduction will prove temporary as it did back in 1974-75, that the current policy of reducing monetary growth will be reversed as pressure to stimulate the recovery develops, or that a collision between huge Federal borrowing requirements and continued monetary restraint will occur. What I am saying is, the confidence was so shattered by the experience and the policy of the last decade, and there is so much concern about whether these deficits will be reduced in the outyears, that it is feared that inflation will return. The interest premium has therefore remained high.

This also has a secondary effect. It not only increases or keeps the yield on long rates high, but it also encourages businesses or other enterprises to borrow at short-term rates rather than refi-

nance their balance sheets as they normally would in a period of recession. There is thus a great deal of pressure in the short-term market, due to the unwillingness of business to finance long unless the picture is clarified or improved.

Finally, in the last 3 or 4 weeks there has been upward movement in interest rates primarily because of the big overshoot in money supply growth in December and early January, and the realization that the Fed would have to take offsetting steps.

The money supply number Friday, which was way down beyond expectations, has eased that concern. It has convinced the money markets, or at least hopefully has, that the money supply is coming back onto the Fed track.

There won't have to be further extraordinary tightening, and that should help the downward trend that we saw last week continue and some of this rise in the short-term market could be reduced.

Ultimately, we are going to have to prove over several years that we are going to keep this policy intact, if we expect that unusual relationship that you cited to be reduced, and the premium to be steadily reduced.

Chairman ROSTENKOWSKI. Mr. Downey will inquire.

Mr. DOWNEY. Thank you, Mr. Chairman.

In Saturday's Washington Post, there was an ABC-Washington Post survey that said that nearly two out of three favor abandoning the Reagan taxcut proposals. It seems to me that there are two essential changes since the last time you testified before the committee.

One, policies have not worked. Indeed, there is a recession, a deepening one. I am not sure whether it was long building and unforeseen, or foreseen and upon us when you testified. I suspect it has been building for a long time, and we had some sense that it was coming. At any rate it is here now.

Members of Congress have gone home. I have talked to my own constituents. They are deeply worried about the President's plan.

It is quite clear that there are going to be wholesale changes in this plan. It concerns me that this notion of compromise emanates from some White House officials and not others.

You seemed very conciliatory last week before the Budget Committee, Mr. Baker the other day on one of the news programs suggested that there was a two-way street. I fear that the two-way street is really an alley, that coming down the alley is a Mack truck, and that the Members of Congress that stand in its way are going to be hit by it.

I am concerned about the President and—I asked you in the most delicate and most sensitive way possible—a report on the lawmakers that I saw last week, to the effect that since the President's assassination attempt, he believes he has been spared in part to fulfill his economic and defense plans.

Have you detected in any of the meetings that you have been in that the President has something other than economic justification for continuing a plan that is in the process of failing?

Mr. STOCKMAN. I would have to say in all candor that that is not a proper question for me to comment upon here or for that matter anywhere else.

I think that kind of speculation is not helpful at all and detracts from the problems that we face, the choices that we face, and the merits of the policies that were introduced last year about which you and others may have second thoughts.

I think the President is as firmly convicted and convinced today—for the same reasons as he was a year ago—that we can't retreat on defense, and that we should not change or alternate, in fundamental ways, the tax program put into effect last year.

I think he has a longer perspective than perhaps you or others on this committee. This recession is not going to last indefinitely. This recession is a correction of undermining imbalances in the economy, a normal business cycle, and it has built in forces of recovery and correction. Those will be underway the next time we meet, and then we can ask, as recovery moves forward, whether or not the business and individual tax incentives are helping or hurting, but let's not judge a permanent policy from 3 months' worth of economic condition that have occurred before and perhaps will occur some day again.

Mr. DOWNEY. In your Atlantic Monthly article published in November, you indicated that you felt there was a $10 to $20 to $30 billion swamp of waste in the military budget.

It seems to me water has been added to that swamp as opposed to any heat source to dry it up. Why do you now come before this committee in February and suggest to the chairman that there is no waste, there is no way we can cut defense spending?

You outlined a whole series of things that could be left alone, that I agree with you. Operation and maintenance, pay and facilities, and other things like that should be left alone. But let me use a Stockman technique.

The procurement budget goes to $89.55 billion, up from $65 billion in 1982. In 1983, the procurement budget will be double the procurement budget of 1980 when it was $35 billion.

Are we going to get twice as many weapons in 1983 over 1980? Is there no room for cutting the procurement budget and leaving it possibly at $75 billion? That is the area where we had discussion, $12 billion worth of cuts will still leave us double the 1980 level.

Mr. STOCKMAN. You need to examine every one of those proposals in the budget.

Mr. DOWNEY. Let me ask you about the MX missile.

There is no basing mode for the MX missile. We don't know where we are going to put it, and yet there is several billion dollars, about $2 billion here for the MX missile. Why can't it be cut?

Mr. STOCKMAN. Mr. Downey, I would answer that by saying clearly we need a follow-on missile. Clearly there are a variety of options for basing. It will take some time to produce that missile and in the interim, those basing choices, both interim and permanent, can and will be made. Rather than debate precise basing mode, it seems to me we ought to go back to the underlying need and that is, one, is land base deterrent modeable? In my judgment, the answer is yes.

Second, can we do without a land base deterrent? My answer is no.

You perhaps have other views on it and that is what the debate about that item in the budget is all about.

There is waste, generically, inherent in the defense budget and in the Pentagon. Everybody admits it and I believe we have got some pretty aggressive actions underway to minimize it wherever possible. In fact, $20 billion worth of savings in the area of operations and procurements have already been identified.

We should do more and I hope the Congress will press the Department to do more. However, I would urge that you not pressure the progress that we are making on reducing waste by reducing the size of the defense budget authority request or outlays, because obviously, that is not an appropriate measure. We may have to use some of that money for things that we need that are being deferred or neglected at the present time.

Mr. DOWNEY. When you or any member of the administration are asked about social spending programs, we are given a litany of how gigantic the number of meals that we serve is, and how many people are richly held by the safety net. What I am suggesting to you is that this is a chopped liver approach. That we have millions of free meals given out today is an invalid way of looking at the social side of the budget. It is deeply invalid because the procurement budget has doubled in size of the 1980 level. We are somehow going to have more defense because of it. I urge you to tell the President and his advisors that the budget is not going to pass as it is. They have to recognize that savings in defense have to be made and the sooner they do, the sooner your credibility and the credibility of this administration will rise.

Mr. STOCKMAN. I agree with you 100 percent. You can't solve these issues with roundhouse numbers, whether you have to cut the domestic programs too much or increase the defense budget too much.

You must look at the detailed choices, look inside that $89 billion in procurement, and decide whether you think those things are necessary. But $7 billion of it is for two carriers. You can judge whether or not you needed to have a 15-carrier force capability. That is a detailed specific policy choice.

This administration believes it is necessary. You have other views and the process is designed to resolve those differences as we move through authorization and appropriation.

Chairman ROSTENKOWSKI. Mr. Heftel will inquire.

Mr. HEFTEL. Mr. Stockman, I think you have been telling us that somehow we should excuse the error of your projections, because you figured out a way to say that others were also in error.

As I recall last year, I spent most of my time with my constituents explaining to them why I had to oppose your economic program. I had to explain why an individual tax cut which didn't impact on productivity would not produce increased GNP.

I had to explain to them why we were going to have a $100 billion deficit, because you had understated your interest expense and you had overstated your revenue.

I had to explain to them why your depreciation program would not stimulate jobs and new, meaningful investment.

I had to explain to them why your program would be looked upon by the money market and the sophisticated investor as a disaster, because they would calculate the same $100 billion deficit, and they knew interest rates would stay high and they didn't want

to get caught in that maze that you have created. So I spent the year sharing this with my constituents, and even sent out 15,000 copies of a long explanation of why I couldn't support what you were proposing.

I am not the only one who knew it would fail and not the only one who knew we would be where we are today. I don't understand why you are not analyzing what you did, figuring out where it failed, where it was wrong and then try to rectify it.

You act as though you can't admit or correct a mistake and must somehow go and carry the mistakes with you, make or break.

Mr. STOCKMAN. Well, Congressman, let me respond. I don't think that we are trying to suggest here that mistakes were made, or that the ability to rectify the current situation that we face isn't there, because that is what the whole budget program is about this year.

You may have a better solution, a different route, a different mix of options to pursue, but clearly those are the facts that we face today and we are making an effort to deal with them.

Mr. HEFTEL. How can you solve the problems we have got if you don't start with the mistake that you have made?

Mr. STOCKMAN. I disagree with that premise. If you look at the major changes that I have described to you, it is hard to say that any of them result from the policy or the program put in place last year.

The recession started in July. That is a fact. The policy didn't pass until August and wasn't implemented until October, so let's not blame the recession on the policy, at least in terms of what you were debating here on taxes and spending.

That was something that had built up in the economy and then the tight money probably triggered us into a recession. The second big change in terms of the deficit forecast is due to the fact we now expect a lower inflation rate than we did last year and a much lower one than anybody else expected.

That is a positive development, but it has the perverse and peculiar effect of worsening the budget deficit temporarily. In other words, the reward for the good news is that you have bad news on the budget.

That also happens to be a fact of life and perhaps it should have been better understood by you, I, and others who advocated an anti-inflation policy in this country—I know you did, and we got one and it is working.

Inflation is coming down and we are discovering the precise magnitude of the unexpected problem that we have temporarily on the budget side.

Again, that is something that we have to deal with. It does not represent an error in the policy.

The one place where we do have an error, if you want to use that term, is we simply underestimated the turbulence, pressure, and uncertainty that would develop in financial markets as this transition unfolds in the face of these large deficits that we now are projecting. Perhaps we should have had higher interest rates, but that is only a small part of the total difference of what you have cited, and we have attempted to correct that this year with a more realistic interest rate forecast for our budget estimating policy decisions.

Mr. HEFTEL. Sir, you still have not addressed one of your problems, namely, that you gave away your tax program and got nothing back for it.

As a result, you are suffering and have no room in which to move. You are looking for the wrong kind of tax increases now and you are still not going back to address what you did wrong in the first place. As long as the marketplace knows that those gimmicks are in place to be exploited, and that those tax cuts won't produce the economic activity we must have, investors will not invest.

They will hold back what they have and will continue to anticipate recession, high interest rates, high deficits, and as they look at today's deficit projection, they know the problems will continue.

They know they are also too optimistic and that the actual deficits will be higher. Therefore, until you address what you did in the tax cuts, until you address problems such as our declining productivity growth rate, you will not have solutions people can rely upon.

That means in turn that you will be back here a year from today with the same sort of scenario and the same failures. I am waiting for you to formally admit that you have got to make changes in what you did wrong, which many of us told you was wrong, but you refused to listen to us.

Chairman ROSTENKOWSKI. Mr. Gradison will inquire.

Mr. GRADISON. Thank you, Mr. Chairman.

Mr. Stockman, in his questions and comments, my colleague, Mr. Downey, talked about the Mack truck. I think the closest thing we have seen to the Mack truck so far is your testimony.

It is a very powerful argument that while changes can be made in the budget, they are likely to be on the fringes. I am not sold on every aspect of this budget, but I must say the longer the discussion goes on, and the more hearings that are held, the better that budget looks, and the less leeway, I think, that there is within the Congress as far as choices to be made without throwing the budget into even greater imbalance.

So I want to start by recognizing the job that has been done so far, and indicate my own hope that we can use that as a meaningful vehicle recognizing that there are going to be some changes along the line before a final product is developed.

I just have one area of questioning I would like to pursue and that has to do with the savings rate. The projections of private savings, including business savings that are built into this budget suggest that in the next few years, those savings rates will reach a level higher than anything we have experienced in this country in the last generation, and I hope they will.

The figures are not unreasonable and they show a gradual increase, but those savings rates, if achieved, come in the outyears, 2, 3 years out or later, but this very heavy Federal borrowing comes in the almost-immediate future.

Can you share with us any estimates of the proportion of the available credit which you anticipate to be available in the economy through noninflationary financing means over the next year or two which will be absorbed by Federal borrowing on- and off-budget, assuming that the budget is adopted as proposed by the administration?

Mr. STOCKMAN. Mr. Gradison, there are really two ways to measure that. One is the Federal on- and off-budget requirement relative to gross private savings, corporate and household.

That will give you a relatively low ratio in the 10- to 20-percent range. Another totally different way to measure it is Federal borrowing requirement, on- and off-budget, relative to total funds available in the credit markets—a flow of funds measurement. I would have to supply the precise numbers for the record.

There is a problem estimating the flow of funds available, so the estimates are subject to a wide margin of error.

[The following was subsequently received:]

FEDERAL AND FEDERALLY ASSISTED BORROWING AS PERCENTAGES OF SAVING AND FUNDS RAISED

Fiscal year	Gross private saving		Funds raised in domestic credit markets	
	Federal	Federal and federally assisted [1]	Federal	Federal and federally assisted [1]
1981 actual	17.1	30.7	19.4	34.8
1982 estimate	22.1	39.5	NA	NA
1983 estimate	17.3	32.8	NA	NA
1984 estimate	13.4	NA	NA	NA

[1] Includes guaranteed loans and borrowing by Government-sponsored enterprise.
NA—not available.

Source: OMB, Mar. 8, 1982.

Mr. GRADISON. I recognize the statistical problem and would appreciate any figures you could submit for the record, even if they are just ranges, recognizing it is impossible to pinpoint a specific number.

My sense of it is that there is a growing concern in the credit markets that we are going to borrow now and save later and that is almost inherent in the economic plan because of the difficulty of boosting the savings rate, especially in the business sector, during a recession, and it would be helpful to take a look at the projections that you see in order to attempt to quantify this, and whether it adds fuel to the fires of doubt about the plan and has an adverse impact on interest rates or not, I really don't know.

We need more facts on this and I have had great difficulty getting them in a meaningful manner.

Chairman ROSTENKOWSKI. Mr. Matsui will inquire.

Mr. MATSUI. I want to thank you for appearing here today.

I want to ask you basically about your comments, and the reason we have this high deficit this year. You gave principally three reasons, and one was that the recession occurred and we didn't anticipate it.

Two, the fact that the inflation rate has gone down more rapidly than you would have expected, thereby creating a loss of revenues and, three, that the reaction of the financial markets was not anticipated because of this transitional phase in the Federal Government.

With the inflation rate down much greater than we had anticipated, there is a loss of revenues much greater than we anticipat-

ed, but at the same time, expenditures would be much less, too, as a result of that, is that not correct?

Mr. STOCKMAN. That is true as a basic proposition. However, in terms of the timing and in terms of the magnitude, there is a large difference. I would refer you to part 2 of the budget where that is demonstrated. I also would like to cite the figure, because I think it is important to recognize that it is not asymmetrical. For instance, in 1984, as a result of the lower than previously forecast inflation rate, outlays will be down $6 billion, but receipts will be down $57 billion. These changes are the result both of the one-time drop of GNP during 1982 and the less rapid growth rate thereafter due to lower inflation.

The impact is much larger, much sooner, and much more severe on the receipt side versus the outlay side of the budget. Over time it comes back into balance, with the exception of social security. To calculate the social security COLA's, one has to go back 1½ years, that is, the 1983 COLA will be based on the actual inflation rate in 1981 whereas receipts will be generated by the inflation rate that actually prevails during 1983. This is therefore an added burden that results from reducing inflation.

Mr. MATSUI. You would figure that within a 24-month period you would end up picking up that loss in terms of the inflation rate and expenditures, because in fiscal year 1983 and 1984, the COLA would be much lower, and expenditures would thereby be much lower?

Mr. STOCKMAN. By 1986, 2 years later, the savings on COLA's and other indexed costs will be $12 billion, but the reduction in receipts is $62 billion. It is a compounded effect.

Mr. MATSUI. When you were being interviewed by Mr. Greider, did you tell him that in January 1981 when you first became the OMB Director, you substituted for the traditional economic model used by OMB, the entire Reagan economic program—the tax cut, increase in defense spending, the regulatory reforms to the extent that you were able to do that—and also the Volcker proposal in terms of the tightening of the money supply? Did you also advise him that the results in 1982 would be a $82 billion deficit and in 1984, $116 billion deficit?

Is that not a correct statement?

Mr. STOCKMAN. That is not quite a correct statement reported by Mr. Greider.

One, there is no computer at OMB that captures the whole economy, that can crank in inflation and tax policies and so forth. We add together all the budget estimates developed by the agencies after they are given the economic forecast that is developed jointly by all economic officials and agencies in the administration. There is no central computer that can predict all of this.

Second, when our economic forecast for last year, which was published in the February 18 document and discussed here this morning, was used to estimate the budget for fiscal year 1984—with the full tax program in effect as proposed 10/10/10—it resulted in a $116 billion deficit, just as the article indicated. We then proposed on page 5 in that same document 86 billion dollars worth of on- and off-budget spending reductions for 1984. We also indicated in that document that an additional $31 billion in further savings

would be needed in the future in order to reduce the on- and off-budget deficit from $116 billion to zero.

When the final budget was presented in March, that $30 billion increased to $44 billion as a result of some reestimates and so forth, but basically the numbers were presented in their totality on February 18, and there is no mystery about the $116 billion.

The $116 billion—as provided in that paper—would have been the deficit if the spending reductions, which were an integral part of the program, had not been proposed at the same time or had not been implemented.

Mr. MATSUI. Mr. Greider's article appears then not to take all of your general efforts into account? He apparently makes the statement that you used the Reagan economic program as part of your assumptions which resulted in a $116 billion deficit.

Mr. STOCKMAN. That did not include the spending cuts, no.

Mr. MATSUI. You did make some different assumptions then after all. So Mr. Greider was right in saying you are incorrect in this analysis.

Mr. STOCKMAN. I don't think contextual exegesis is going to get us very far.

Mr. MATSUI. I would like to know whether Mr. Greider's article is correct or if you are correct. I didn't ask to see your White Paper. I am asking you.

Mr. STOCKMAN. That is the published document explaining the administration's program. That document will show that with the tax cut and our forecast there was a $116 billion deficit. The spending reduction program reduced the deficit by $86 billion, and we proposed $30 billion more in spending reductions for consideration by Congress at a later date. Thus the $116 billion is reduced to zero.

Mr. MATSUI. In view of the fact you are not saying Mr. Greider's article has some credibility problems with it, and contrary to your other statement that there is no anticipation of a large deficit and that in fact you had anticipated a large deficit, you deceived the Congress and the American people by changing those numbers. I happen to believe Mr. Greider's comments.

Mr. STOCKMAN. I will rebut them, and I wish that he would retract them in a broader statement, because they are at variance with the facts.

What I just told you was how, with the spending reduction program and the tax cut program—as laid out in hard, factual numerical detail in 20,000 copies for everyone to read on February 18, a potential 1984 deficit of $116 billion without spending reduction plans was reduced to a balanced budget.

Mr. Greider simply got that part of it wrong.

Chairman ROSTENKOWSKI. Mr. Bailey will inquire.

Mr. BAILEY. Thank you very much.

I think you folks have a little egg on your face, and I respect the way you are trying to deal with that problem.

On page 34 of your statement there, you made reference to alternatives, and in your desire, I assume misery loving company somewhat, to spread the responsibility for the difficulties we are in and your inclusion of econometric forecasting and predictions based upon the impact of hypothetical alternatives, ours included, which

did not come to pass, that alternative was arrived at in a very heated political environment dictated and controlled very much by the administration.

When we came up with that alternative, we felt that we were under pressure not to do as many of the productivity improving things we wanted to do, and we wanted to come up with a 1-year cut.

We reacted politically as we had to and you folks did the same. Indexing might be a good example—no reflection on my colleague who I think would have voted for it anyway.

The most important thing to do now, I suppose, because I don't think you are going to be successful in changing the environment of responsibility, because I think it is yours.

Recovery is the issue now. We have got problems to solve and we are going to have to work together to solve them. Leasing and corporate taxes. You have never been known to be a super supply-sider; but if that word productivity means anything in context, leasing and corporate minimum tax with user fees, what kind of contribution do you think we are going to make taking your 2.5 billion dollars' worth of cuts, for example, of revenue raisers in that user area?

You are going to shut down the Allegheny River in Allegheny County in western Pennsylvania.

You are going to cause tens of thousands of jobs to be lost and decrease the tax base by that much, and there are no alternative maintenance programs on line or public works projects supported by the administration to solve the problem of the decreased maintenance.

How do you analyze something like that? We have never seen that requested of two administration witnesses, analysis of user fees, the cost-benefit relationship, the impact of that lack of investment. What happens with the revenues that are replaced by the user fees, relationship between benefits, in other words, the jobs created, the impact on a local or regional or national economy of imposing users fees.

Politically, it may be popular, we just don't know. Mr. Heftel touched the issue when he talked about the courage to do something on the revenue side, perhaps with the income tax area.

I would also like you to respond to this, defense. You are not doing anything with Army modernization. Army percent spending of defense expenditures sinks to 23 percent.

Now, again, we may argue that that is some argument dealing with tactics and modern warfare and that kind of thing, but you have set Army modernization aside.

General Slay made a report when I was on the Armed Services Committee, on the full-year funding, getting into multiyear contracting.

I am sure you are familiar with that concept. What are you doing about it, because some of your procurement practices are the changes we can talk about because we can save billions of dollars. Lastly, resource shortages, stockpile problems are also part of national defense as are capital-intensive industry problems.

You take that minimum corporate tax and add one more burden to the mining industry in this country, we are not going to be de-

veloping that cobalt down in Missouri, but buying more of it from Africa and these kinds of problems continue to grow.

Are you coordinating those types of policy considerations?

Mr. STOCKMAN. Mr. Bailey, we are trying to coordinate. I will try to answer the various parts of your question. On multiyear procurement, we are doing precisely that. We have a dozen systems at the present time that are being put under multiyear procurement. We believe there will be substantial economies realized as a result of the greater certainty of the production runs. I would have to provide a number for the record, but it is over a billion dollars over the next couple of fiscal years.

[OMB subsequently responded:]

The current estimate is $1.1 billion over the period 1981–87.

Mr. STOCKMAM. Second, on Army modernization, I think you would want to—when the opportunity arises—quiz the Defense Department more about that, but I do know we have three big costly systems going now that constitute modernization. The tank, the armored personnel carrier, and the attack helicopter. Whether that is the proper allocation or those are the proper choices, I would leave that up to you to judge. That is part of the budget.

The most important question that you asked was on user fees. There, I think, is ample and substantial logic to suggest that you will get more investment, more production, and more national income as a result of these user fees than you will without them because the current subsidies for one mode of transportation today versus another cause a misallocation of capital, a misallocation of traffic, and an excess of cost within the system.

That is not always pleasant news for the individual area or river or transportation system that may be affected. I think it is a consensus among economists from one side of the spectrum to another. They agree on very little, but they do agree that we ought to recover the right-of-way costs from barge operators, just like we do from truckers that use the highways and from other modes of transportation. I think you will find that principle throughout the user fee proposals we have made.

Chairman ROSTENKOWSKI. Mr. Martin will inquire.

Mr. MARTIN. Thank you very much, Mr. Chairman.

Mr. Stockman, your general summary is if we adopt the President's proposal or something like that, the deficit would be projected about $92 billion for 1983 and if we do nothing, the deficit would be substantially higher; is that correct? Around $150 billion?

Mr. STOCKMAN. That is correct.

Mr. MARTIN. So the President has said if the Congress is not willing to adopt his budget proposals, come up with something different. Of course, we are anticipating hearing alternative proposals. So far there have been few alternatives presented.

Senator Hollings of South Carolina has submitted such a proposal but otherwise it is important to notice that no one is seriously proposing that we go back to unrestrained Keynesian expansion as a way of solving the recession that two decades of unrestrained Keynesian expansion got us into.

Let's talk about Senator Hollings proposal a bit. I think there are some good things in it. I hope we would wait and see if there

can be built some bipartisan support for some of the differences in combination with some of the things the President has proposed so hopefully we can get the deficit down below $92 billion.

He has mentioned in addition to a freeze on defense, he has mentioned reform of cost-of-living adjustments for a wide range of entitlements programs. My first question is is it possible to balance the budget by 1984, 1985, 1986, or 1987 without doing something to restrain the expansion of entitlements?

Mr. STOCKMAN. Mr. Martin, I think the answer is that the cost of these indexed programs will be substantial over the next several years and we are going to have to address them at some point if we expect to eventually eliminate the deficit. We have not made proposals on the social security indexing mechanism and COLA in this budget, primarily because we have reserved that issue for the Bipartisan Commission on Social Security and because we would like to see some consensus recommendations that could span any partisan differences out of a desire to get them adopted and not just proposed.

It is easy to propose, as we know from experience the last year and a half. It is very difficult to get anything adopted. We would see action taking place, but it is not projected in this budget because we await the Commission finishing its report.

Mr. MARTIN. I can understand that. Unless there is bipartisan support for the initiatives there, you are going to be treated to the same sort of blistering savagery you got from the leadership of the House of Representatives earlier last year. Is there any indication now of any growing bipartisan congressional support for that part of Senator Hollings proposal?

Mr. STOCKMAN. I think I would return the question to you. I am not sure what the reaction has been up here. That should be apparent as we go through this process during the next few weeks of looking at all the options.

Mr. MARTIN. On another part of his proposal, having to do with defense, there has been some indication that maybe you will not get the votes around here to raise defense spending by as much as the Pesident has proposed.

I kind of doubt you are going to find a majority wanting to freeze defense as we did for the previous 15 years prior to President Carter's last year either; but it occurs to me if it is vital, as I think it is, and as you think it is, to boost defense spending in this country, would it not be just as vital to pay for it with a targeted earmarked temporary surtax or excise tax or corporate minimum tax or something of that sort to indicate if we are going—if we have the necessity of building defenses, that we at least pay for that?

Mr. STOCKMAN. I think that is one of the few new ideas I have not yet heard and it is one of the more creative proposals that thus far has come from the Hill. I think perhaps you would want to analyze that very carefully. I have no immediate reaction. It has not been considered by the administration.

I would offer one caution; that is, the idea of earmarking taxes for specific general purposes of government, outside the trust fund or dedicated user fee account areas, is one we should approach very carefully and very cautiously, lest we set a precedent for earmarking all kinds of taxes for all kinds of purposes in a way that simply

makes budgeting impossible. I think that idea needs to be examined carefully, but it does have implicit in it a large precedent that, to me, would be quite worrisome.

Mr. MARTIN. Before my time is up, there is one area of Senator Hollings proposal I want to raise with you. He proposes repeal of about three-fifths of the personal tax rate cuts which is not a change from his position. He was opposed to the personal tax rate reductions all last year and also to repeal indexing.

It seems to me if we accept Senator Hollings proposal to repeal indexing, would that not just mean that we would return to unrequited bracket creep with millions of taxpayers being lofted into higher and higher tax brackets with medium income in another 12 or 15 years being up to the 50 percent maximum tax rate on earned income?

Is that not what he is proposing?

Mr. STOCKMAN. I do not believe that is his intention or that is his proposal, but that is the risk you run. It is a very severe one. I think that is the reason Congress in its wisdom, included indexing at the end of the tax cut period last year, in order to safeguard that tax cut against future inflation.

Mr. MARTIN. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Anthony will inquire.

Mr. ANTHONY. Thank you, Mr. Chairman.

Mr. Stockman, a while ago you made a statement to Mr. Jenkins that the program had not begun until 1981. That is a correct statement?

Mr. STOCKMAN. That the program——

Mr. ANTHONY. Had not begun until October 1981? Is that a correct statement?

Mr. STOCKMAN. I think, in the main, that for 98 percent of the cases that would be true. There were a few spending cuts that took effect in 1981, but most of them were fiscal year 1982. Some limited provisions of the tax bill took effect before October, but most of them became effective October 1 or at later dates, including major changes in January 1982 for IRA's, et cetera.

Mr. ANTHONY. Let me go down through a checklist I have. One leg of your program was tight money. It began October 6, 1979. So the financial markets did not have to look on short-term gyrations of the M_1, they could look at the latter part of 1979, all of 1980, and all of 1981.

The Fed is right on target for tight money for 1979, 1980, and 1981. There should be some stability in the financial markets if they want a tight monetary policy, because they have had it good for 2¼ years.

January 1, 1981, was a half of another leg; the business tax cuts. June 1981 was the effective date of another part of the business tax cuts. Another leg or part of the program was to cut regulations. That started January 22 when the President announced five initiatives. He established a task force on regulatory relief chaired by Vice President George Bush; he immediately abolished the Council on Wage and Price Stability, saving the Government some money. He postponed the effective date of pending regulations until the end of March.

He put forward some rescissions and deferrals. So it appears to me when you really analyze the four point program, that it is not fair to say in any stretch of the imagination that it did not begin until October 1981. In truth and in fact many parts of the program were put into effect before the administration came into office.

In 1980, we cut spending using the reconciliation process for the first time. We did not use it last year for the first time but under Carter's last year we used it for the first time when we cut $4 billion in spending.

It appears to me that it is a grossly inaccurate statement to continue to say that the program did not begin until October 1981.

Mr. STOCKMAN. If I could reply to that, Mr. Anthony, my point was in response to the question. Many people blame the individual tax cut, which was the centerpiece of the program, or the budget reconciliation, which was the large package of spending reductions, for the recession. As I indicated, these are 95 percent of the program in terms of dollar impact; and they clearly took effect after October 1.

Yes, the monetary side was in effect before October 1 and in my testimony I indicated that the unexpected and perhaps undesirable sudden drought of money last summer contributed to the recession. We have never denied that and we have never suggested otherwise, but the attacks that I hear, that I feel need to be defended and corrected, are that somehow the tax cut or the budget reconciliation bill were responsible for the recession. Clearly that cannot be.

Mr. ANTHONY. I am not really concerned about trying to lay blame. I just get a little bit disturbed when you continue to say that the program did not start until October 1981. Now you are saying that the personal tax cut—did you use the term 90 percent?

Mr. STOCKMAN. I am not sure of the fruitfulness of this line. I merely suggested that 90 percent of the programs——

Mr. ANTHONY. What did you say a while ago?

Mr. STOCKMAN. I said in some metaphorical sense 90 percent of the program is identified with the big budget reduction package and the individual tax cut.

Mr. ANTHONY. I am trying to get it straight in my mind so when I go home to explain it, I say everything that is right. The white paper you talked to Mr. Matsui about, is that the same one presented to us February 18, a program for economic recovery? Or is that a different one you are talking about?

Mr. STOCKMAN. It's the same one.

Mr. ANTHONY. On page 5 that you talked about, it talks about Government contributes to the productivity slowdown and has some real nice charts.

Mr. STOCKMAN. Page 5 of the budget part, Mr. Anthony. You are reading the economic report which was the first section of the book. If you turn to the second section of the book you will find the same page 5 that I was referring to.

Mr. ANTHONY. On page 12 of that particular document it talks about the same period of time of having a surplus rather than a deficit, same period of time Mr. Matsui was talking about.

Mr. STOCKMAN. Maybe perhaps after the hearing I could find the page for you.

Mr. ANTHONY. One final question. Two economic questions.

The remaining deficit of $92 billion that you explained on page 2, I just simply would like to know the amount that you contribute to the slowdown in inflation in dollar numbers.

Mr. STOCKMAN. It is very difficult to disentangle the composition of nominal GNP between inflation and the level of nominal GNP due to the recession in 1982. If you would like a technical work out of that, we could probably provide it to you although in the budget document, in part 2, we have it consolidated both in terms of the recession effect and the inflation effect.

It is very difficult to untangle it. It can be done, but obviously over the long run most of it is inflation, because one thing the recession is doing is reducing dramatically the price level in the economy; and you start from a much lower level of prices in the recovery period than you would have otherwise.

Mr. ANTHONY. That answer satisfies me. Basically you are saying it is practically impossible to put a monetary value on that, but it is part of a total package that does explain it?

Mr. STOCKMAN. What I am saying is the receipts are lower by $53 billion in 1983 and $170 billion over a 3-year period. That reflects a lower path of inflation and a lower path of nominal GNP due to the recession that occurred this year, and that was not expected.

Mr. ANTHONY. One last question. I do not expect an answer today but I do want to have this answer provided to me and made part of the record. If I were the Commander in Chief and invited you to the White House and said Mr. Stockman, you are my Director of OMB, I have now changed my mind and we are going to have to cut defense spending between $10 and $15 billion and I want you to go back to the drawing board and come back to me with where you can make those cuts and where we can do it and still not hurt our military preparedness.

Let's just——

Mr. STOCKMAN. You are asking me to respond?

Mr. ANTHONY. I do not want you to respond today. I really want a detailed, written letter under a hypothetical that I have challenged you to find me $10 to $15 billion in military savings and still not hurt our military preparedness.

I do not know the military budget like you do. I do not know the entire budget like you do. I would like you to just take your time and go through and find where you could make those cuts, make that presentation to the President, and I would just like to see what you would tell a person like that in the Oval Office if that challenge was presented to you.

Mr. STOCKMAN. Mr. Anthony, if you were in the Oval Office, I would be happy to do that. Under the current circumstances, I do not believe it would be appropriate for me to develop the alternatives.

Mr. ANTHONY. If you are not willing to do that, I suggest you not criticize this committee or the Congress when we try to do that.

Mr. STOCKMAN. I have not criticized this committee.

Mr. ANTHONY. I suggest you tell your administration not to criticize this committee. If you are not willing to lay out a bipartisan proposal we can compare to see if we are right or if we are wrong.

Mr. STOCKMAN. Mr. Anthony, let me state it differently. Sure, someone could lay out a $5 billion cut, a $15 billion cut, a $25 billion cut. What you would then have to do is show the costs and benefits, the budget savings achieved versus the risks incurred, the loss of capability incurred, and the erosion of capacity to support certain objectives or missions of various armed services as the case may be.

If you would like that kind of analysis, I would be happy to provide it. But you have to recognize in cutting the defense budget, you are going to run these kinds of risks. It is up to you to judge whether they are worth while to take.

Mr. ANTHONY. I will leave my request on the record. You respond the way you want.

[Nothing further was received.]

Chairman ROSTENKOWSKI. Mr. Guarini will inquire.

Mr. GUARINI. Dave, you have always been articulate and sometimes perplexing. I respond to what just was asked of you. I should imagine if you do complete that analysis that Mr. Anthony arrange for a civilian Purple Heart.

The budget process is rather dramatic. I want to commend you on the way you have stood very steadfast. I do disagree with many things that have been said. I voted against the budget last year. It did not make sense to me. I cannot understand where you can cut taxes $750 billion in 5 years and not get into some kind of problems in the balancing of the budget.

It was when Lyndon Johnson took office, if I remember my history, that he said he would keep the budget under $150 billion. It was then $98.5 billion. That was only a few years ago, within the memory of everybody in this room here.

What I am really concerned about is not just the $92 billion deficit, knowing that economics involves guesstimates and we are often wrong, not being able to ever take a scientific approach. I am interested in the baseline economic assumptions that you have used, because assuming all the things that you have said, we are in serious trouble with the $92 billion deficit.

I am concerned about things like the interest rate assumption, which you say is 10.5 percent. We are paying around 14 percent Treasury notes now. If we go out and borrow a trillion dollars, just being off 3.5 percent is $35 billion additional interest we would have to pay above the $92 billion deficit.

I am concerned about the unemployment rate which affects our tax collectibles, because you assume that it is going to be 7.9 percent. It is now 9 percent, and I do not see it getting any better. When I was back home this past week, Owens Illinois, which is a major company, closed its plant, laying off 500 people in my district. Two Guys from Harrison, the largest retail outfit in my area, closed their three stores and that laid off almost 1,000 people. So I have had 1,500 people within the last few days unemployed. So I seriously challenge your unemployment rate.

You are assuming a Consumer Price Index of 6 percent. I must say the way things are going now, if we are forced into a depression, we might even head into a minus figure. It could be deflationary which would be unfortunate in certain ways.

But the industrial production on the real GNP growth you assume will be 5.2 percent. According to the news that we got from last week, industrial production is down 3 percent.

I see on the front page of the newspapers that a thousand savings and loan institutes may merge or fail. There are serious economic problems out there. These assumptions you have made are very, very frightening to me because they do not seem as if they have any basis in fact and they are only just guesstimates.

If you are wrong in these basic assumptions you have made for our baseline and if we are going to have a deficit in excess of $92 billion—which could well happen if you made a mistake in our tax collectibles, our inflation rate, our Treasury notes, our unemployment rate and real GNP growth, what backup plan do you have? What do we fall back on? What do we do at that time? How do we prevent our economy from being dismembered because we cannot turn around 223 million people on a dime instantly?

There is also a long time lag. I would like to know what backup plan the administration has if by chance—and I hope to God that you are not wrong—but if by chance you are wrong, Dave?

Mr. STOCKMAN. Well, let me try to answer the question this way: Before I discuss a backup plan, I just want to point out to you that each of those economic indicators you cited is the average for calendar year 1983.

Mr. GUARINI. With the $92 billion deficit these particular figures could be well underestimated. CBO is now upgrading their estimates, which is going to result in an even greater disparity between you and CBO.

Mr. STOCKMAN. I could say this, though: On the basis of the CBO forecast, as it exists now, the deficit will be $7 billion higher in 1983 because they have slightly higher interest rates and slightly lower real rates of growth and so forth. If you would rather take their assumptions, then you would add $7 billion on the economic forecast issue alone.

Mr. GUARINI. If you take the figures we have today and if in the real world out there—not in the world of fantasy, which is often Washington—in the real world, if there is higher unemployment, if our tax collectibles are down, if the Treasury notes we have to borrow on do go up 3 or 4 percent, what do we do then? We will be facing a $100 billion, $150 billion deficit instead of $92 billion. What do we do at that time?

Mr. STOCKMAN. I agree with you. I don't think all of those things are likely to happen at once. If the economy gets weaker and unemployment gets higher, the interest rate is more likely to go down than up.

Second, you simply have to look at what forces are at work in the economy today, and whether you think a business recovery will occur under the natural rundown of a business cycle later this year and next year. Most forecasters think that is the case. This morning it was reported that the 44 leading forecasters who report the blue chip are expecting 4.1 percent real growth next year in 1983. That is a little below ours. It is strong recovery. Unemployment is coming down.

If you take the whole range of forecasts available, you are going to have a higher or lower deficit; but for 1983, it is not going to be

substantially different, $10 billion either way, than the $92 billion we propose.

Mr. GUARINI. Would you put your professional reputation on the line and say absolutely it will not be more than $10 billion either way of the $92 billion deficit that is projected?

Mr. STOCKMAN. No. That gets to my second point.

Mr. GUARINI. The administration has been wrong before. Congress has been wrong before.

Mr. STOCKMAN. That is true. That gets to my second point; that is, the $10 billion either way is overshadowed by the need to take about $55 billion worth of action to get to the $92 billion in the first place. If that action isn't taken on taxes and spending and user fees and so forth, then in my judgment, we are left with $147 billion deficit—which is what I discussed as current services—and there is no way this forecast can be realized. Under those circumstances you will have higher interest rates, higher unemployment rates, lower growth, a far weaker performance of the economy; and then we will have a self-feeding deficit that will be almost impossible to overtake.

So the contingency plan is simply to implement the plan that we have proposed or something like it, or we will be left in a position where there won't be much of anything that can be done to stem the unraveling that will occur.

Mr. GUARINI. Is there a fixed plan? I press my point. Do you have a fixed plan as a backup other than just to say that we have as a contingency, we may have to raise taxes? Is there a backup plan that we would defer the tax cuts? Is there a backup plan that will get rid of some of the tax expenditures and subsidies given to corporations? Do we have a way out of this marsh?

Mr. STOCKMAN. Congressman, I think there are literally dozens of options available of large and small size that, depending upon the circumstances and the threat and the conditions, could be taken off the shelf and implemented if there were a true crisis of some unprecedented proportion. But under current circumstances, we believe the set of measures we proposed in this budget are adequate and the right things to do to keep the overall program on track. If things turn out much differently, then you might want to look at different things. For right now we believe this is the proper set of steps and measures to take.

Mr. GUARINI. My time is over. You say there are options. We know we have options as a Nation. But, you did not give me any kind of backup plan from what I understand.

Chairman ROSTENKOWSKI. The time of the gentleman has expired.

Mr. STOCKMAN. I would just say this budget is less than a month old. Before we invent a new one, we want to make the best effort to persuade the Congress and the American people that these are the right steps to take under current circumstances as we see them. Obviously events and circumstances change, but there is no point in presenting a contingency now until we have had a chance to deal with this.

Chairman ROSTENKOWSKI. Mr. Rangel will inquire.

Mr. RANGEL. Thank you, Mr. Chairman.

Thank you, Mr. Stockman, for coming before the committee. It is obvious that you are sensitive to the credibility question that has been raised around your feelings concerning the Federal budget.

The chairman asked whether or not you would have the courage, if you differed with the administration's feeling about the recovery package, to respond to the Congress. I think in response to Mr. Anthony that you are telling us we should not expect that honesty in view of the fact that that is what got you in trouble in the first place in the woodshed incident; is that right?

Mr. STOCKMAN. I wouldn't put quite the same interpretation and conclusion on it that you have just indicated. I believe I was appointed to this job to advise the President. Therefore, my advice must exclusively go to him. You have your advisers, your staffs, your CBO, so you can develop options if you don't like ours.

Mr. RANGEL. Any questions I may ask concerning the balance and equity of this recovery package, no matter how you personally felt, your obligation is to protect the President whether he is right or wrong.

Mr. STOCKMAN. As long as I am in the administration, yes. If I ever reach the point otherwise——

Mr. RANGEL. I understand. Maybe some of your Republican friends don't, but I understand what you have to do. Let me ask this: In view of the fact that it is my opinion that these severe budget cuts as they relate to domestic spending are not connected with balancing the budget but appear to be more in line with this New Federalism concept, that is to shift the responsibilities of programs that deal with people to local and State governments, could you tell me any domestic programs where you believe the Federal Government does a better job or will be able to do a better job, with the exception of defense, than State and local governments?

Mr. STOCKMAN. A whole variety of them. I think the SSI program created by this committee that provides a uniform floor of benefits for the disabled, the blind and the elderly poor is an ideal program. There are problems on the margin but basically it is a solid program. It should be maintained. It should be a Federal responsibility.

I think we could go on down the line. Obviously there are many other things the Federal Government does best.

I would offer as a few other examples the programs that we didn't include in the turn-back in the federalism like compensatory education, title I. We believe there is a targeted national responsibility to meet the needs of the disadvantaged. To take another example, Headstart. We believe that program is working well and it should be maintained on its current federally financed and administered basis.

Another example is the Older Americans Act and the whole array of social service and nutrition programs. That wasn't proposed for inclusion in the turn-back or the Federalism initiative either. I think some careful distinctions have been made. Of course, the example you are most interested in is medicaid, where we have proposed that over time the Federal Government could do a better job of meeting needs and holding down costs than the State governments are doing today. We propose to have that program in the Federal Government.

Mr. RANGEL. Even in the programs we have retained that are not included in the new federalism, it appears as though the problems are still going to be there. The expense of maintaining the programs still will exist. You are reducing Federal support for these programs and just shifting them without the funds to State and local governments.

In other words, it seems as though the administration is more concerned with dismantling programs than just reducing Federal expenditures, in order to shift the responsibilities to the States.

Mr. STOCKMAN. Congressman, I would suggest our primary concern is in reducing the budget deficit and the cost of programs, and once that is given, then we must make choices and distinctions and establish priorities as to where that is most appropriately done. I don't think it is shifting. If I could give you one example, which is not popular in your city, we don't believe taxpayers from all over the country ought to pay the operating costs of mass transit. It ought to be paid by local taxpayers at the farebox. So we propose to reduce that. You may disagree with that, but it is based on a defensible point of view.

Mr. RANGEL. You were quoted as saying this new economic theory—Reaganomics—was merely a trickle-down theory. I think anyone that looks at it will realize that when you ask for sacrifices, the large enterprises and the wealthy people in the United States are really not asked to sacrifice anything. As a matter of fact, under the so-called supply side, they have the enjoyment of determining what they are going to do with their share of inequitable income tax reductions which result in windfalls for a lot of our enterprises. I don't see how you can talk about balance and equity when even the President in the state of the Union message did not indicate what happens to the shattered dreams and lives of people that are disengaged, that are unemployed, that lose the retraining programs. I guess my question is, Do you see any difference in this new economic recovery package that you are presenting to us with its decrease in Federal spending for domestic programs than the old, wornout theory referred to in the article about you and that is the trickle-down theory that Republicans have been known to support?

Mr. STOCKMAN. We didn't invent that terminology. I guess your side did, and has used it quite effectively over 40 years. I don't think we have to go into that debate.

Mr. RANGEL. It was attributed to you.

Mr. STOCKMAN. I certainly didn't invent it. I just heard it somewhere. The point I would make is that this was not essentially a sacrifice program. It was a growth program. We did not sit down and say who is going to bear what burden. We sat down and said how can we make the system work more effectively? The answer was less regulation, less punitive tax rates, less government imposition in terms of total spending and the claim on the economy.

Then once that policy had been decided, it was a matter of finding out how you implement it.

Mr. RANGEL. Your honesty really shocks me. It is exactly what I thought. You went into deciding how you were going to do it without any consideration at all as to how many Americans would be hurt. You just went in to see how we could recover. If the benefici-

aries happen to be the wealthy and the large corporations, so be it. You were hoping that somewhere down the line somehow help would be offered in the next decade to the poor.

Mr. STOCKMAN. That isn't the proper interpretation.

Mr. RANGEL. That is what you said.

Mr. STOCKMAN. Let me recite the facts, though. The tax bill we passed last year on the individual side only will reduce taxes by $277 billion in 1983, 1984, and 1985; 46 percent of that money is going to go to taxpayers between $10,000 and $60,000. I don't know that anybody intended it that way, but that is how it comes out. Clearly those are the people that we depend on to make this system expand and grow and create the jobs that people who don't have them today will need.

You can go through any aspect of the program, and if you want to call it sacrifice, that is fine; but that is not our intention. I don't think that is the effect. When we remove benefits to someone who does not need them or someone who wasn't intended to be eligible, I don't think that is a sacrifice. That is a correction. Somebody has to——

Mr. RANGEL. There is no one in the administration that held themselves out as being sensitive to the needs of the aged and the poor in this country. So there has been no spokesmen for them, certainly not from your office and not from the White House. If what you are saying is that you didn't consider initially who was going to have to sacrifice, I don't have any problem with that. It is a consistent trend throughout the recovery package that you presented to this Congress, except I do know that Members of Congress are getting a different reaction from the old folks in their district and the needy people. Obviously between your truly needy and our congressionally needy, there is a wide gap.

Chairman ROSTENKOWSKI. Mr. Pease will inquire.

Mr. PEASE. Mr. Chairman, thank you very much.

Thank you for coming, Mr. Director.

Reference has been made by earlier members of the committee to the wide gap between your projections of a year ago and your projections of last August and your projections now. You have made an interesting explanation of why it is you tried to associate other forecasters as being in the same boat, but the truth is that in your projections the gap is much more wide than it is with the others and raises to me a basic fundamental question of credibility. I think it is either a question of competence in that you weren't able to come up with more accurate projections on which many Members of Congress voted last year for your economic recovery program or it is a case of not having told the truth to Members of Congress.

You admitted in the Atlantic Monthly magazine article that you deliberately misled the Congress on those budget projections for last year, particularly as to the forecasts. My question is, Why is there any reason for us to have any more faith in the figures you have presented us this year, right now, than we would have had last year had we known the truth?

Mr. STOCKMAN. Mr. Pease, let me say two things. One, I never admitted any such thing in that article. If you choose to interpret it that way, it is your privilege. If you choose to confuse the discus-

sion with an incidental issue of that sort, that is your privilege, as well.

Let me go on and go beyond that and say I never asked you to have faith in these numbers. These numbers aren't to be taken on faith. They are to be taken on judgment. We have laid out the real GNP growth path we think is appropriate to expect. CBO has another one. You can listen to our arguments, you can listen to theirs, and you can make your choice.

I have given you a full explanation as to why I think the T-bill path will move from 11.7 in calendar year 1982 down to 10.5, 9.5, 8.5 and so forth. I explained my presumption on the real interest rate underlying it. If you don't think that is analytically sound, chose your own path.

CBO has a higher rate. There is nothing mystical, magical, religious about making budgets. It is a question of judgment, a question of analysis, a question of numbers. All of those are your responsibility as well as ours. If you don't like the conclusions, the analysis, the numbers we come to, you have a 200 to 300 person office at CBO from which to get alternate advice.

Mr. PEASE. Mr. Stockman, the reason I am so disturbed is that the Office of Management and Budget is an official organization. Obviously Americans and the Congress have to rely to a certain extent on figures coming out of that office. Yet last year clearly the figures on which we relied—not myself but some Members—in voting for your economic recovery program were not correct. As a result, we are far, far off in the deficits coming over the next few years. As smart as you are, it is hard for me to conceive that you would have been predicting a budget deficit of $42 billion for fiscal year 1982 as late as last August and now come back and say it is going to be almost $100 billion and have most economists say it is not even going to be $100 billion but more than that.

Why is it that that happens if it isn't that you are juggling the figures to make this administration as good as possible in a very, very bad situation?

Mr. STOCKMAN. We could carry on this conversation to great length. I basically feel you don't understand the process by which a budget is put together. The only way that you can change the figures is to change the forecasts. The forecast is a published set of numbers for GNP, for inflation, for interest rates, for unemployment. There are fixed rules of thumb and estimating techniques that CBO has, and that we have, that we would be happy to share with you. We could use these to re-estimate the budget—outlays, revenues and the deficit—up or down, if you want to take a different set of economic assumptions.

The fact is that a forecast is jointly arrived at within an administration by the Treasury, by the Council of Economic Advisers, by OMB, and others who have responsibility in the economic policy area. It is a consensus product. It is then published and it is on the basis of those published figures that the budget estimates are derived.

In part two of the document this year we have given you alternative economic forecasts and alternative sets of budget numbers. If you don't like the growth path we have laid out, you can take the lower growth path and you get higher deficits. We have given you

the precise numbers right there. If you think our growth forecast is too pessimistic, we have given you a higher one. We show the impact on the budget. The same is true with inflation and the same is true with the interest rates.

What I have tried to do in this budget, given the uncertainty of forecasting at the present moment, is provide Congress with the broadest possible view of where the budget might be under a variety of policy and economic assumptions.

I don't know what more we can do to contribute in a technical sense and in a factual sense to the comprehension of the choices you have available.

The notion that somehow numbers can be juggled and that facts are being kept from the Congress is ridiculous, and you know it. The CBO publishes and criticizes and re-estimates our budget almost as rapidly as we get it into print and distributed to the Congress.

Mr. PEASE. Mr. Stockman, I am not concerned about the credibility of the CBO figures. I am concerned about the credibility of OMB figures. One of your predecessors as director of the Office of Management and Budget, James Schlesinger, said in the Washington Post 2 weeks ago that he believes the figures that you put out last year were dishonest figures intended to mislead the Congress and the country.

I want to know if you are again attempting to mislead the Congress and the country as you prepare figures for the next 5 years?

Mr. STOCKMAN. I obviously am not going to answer that question in the way you would like because there is simply no way to answer it. I am not the sole developer of a budget, of a forecast. If you take a look at this and you reject the assumptions in it, you can get your own. This is my best judgment and our collective best judgment in the administration as to where we think the economy is going.

As for Mr. Schlesinger, you might take a look at the projections he made on energy policy a few years ago and see whether his judgments have been any better than mine. I doubt that they have been.

Mr. PEASE. You say that your figures this year are your best judgment. I presume they would have been a year ago.

Mr. STOCKMAN. That is correct.

Mr. PEASE. Yet according to your statements to the Atlantic Monthly, you deliberately juggled economic assumptions when you got frightened by the implications of the first set of economic assumptions.

Mr. STOCKMAN. Mr. Pease, that is because you weren't listening when I had a conversation on that matter with Mr. Anthony a while ago. That insinuation or implication in the article is wrong and if you will consult page 5 of the white paper, you can see the precise numbers that are discussed in that article and misinterpreted. There is no more or less to it.

Mr. ANTHONY. Would the gentleman yield on that point? By the way, I did find that page. I added them up. You are correct, they add up to $116.6 billion.

Mr. STOCKMAN. Thank you.

Chairman ROSTENKOWSKI. Mr. Ford will inquire.

Mr. FORD. Thank you, Mr. Chairman.

Mr. Stockman, you said in response to Mr. Rangel a minute ago that we have continued the Federal program under the Older Americans Act.

Prior to the budget cuts enacted in the Reconciliation Act of 1981, there were more than ample funds to fund the title XX program which is being administered by area agencies on aging than being funded under the Older Americans Act itself.

If you cut the title XX funds from the $3 billion which was there prior to the 1981 Reconciliation Act to less than $2 billion if the proposed budget projections are adopted by the Congress, we would have less than $2 billion in the title XX program.

If that is the case, aren't we then affecting those programs that provide these area agencies the type of funds that would be needed to administer many of the programs under the Older Americans Act?

Mr. STOCKMAN. Mr. Ford, that may well be true.

I was referring to the Older Americans Act per se and to the nutrition programs, the feeding center programs, and so forth.

Mr. FORD. The title XX program is a support program of the Older Americans Act.

Mr. STOCKMAN. But it is a separate funding, a separate authority.

I would suggest that for title XX we have cut the budget authority level from $2.4 billion, I believe, to $2 billion. There may well be some impact. The direct programs under the Older Americans Act per se for nutrition and services has been cut only from $600 million in 1982 to $568 million in 1983.

Mr. FORD. The title XX program still picks up the slack, really outlining some of the areas for the Older Americans Act.

Mr. STOCKMAN. That is true. I did have some experience when I was in Congress with the area councils on aging. It seems to me they were always an unnecessary layer of bureaucracy that were substantially overstaffed. If we are reducing some of the funding in that area, perhaps it is for the better.

Mr. FORD. Mr. Stockman, in your testimony today you referred to the administration's success in reducing the rate of inflation.

Every time the administration is criticized you and other members of the administration respond by saying that the inflation rate has been reduced.

I would like to just state some facts. The real GNP is down 5.2 percent in the fourth quarter. The industrial production is down to a 20 percent annual rate in the last 3 months.

Only 1,086,000 housing units started in 1981. That is the lowest number since 1946. In December, 40 percent fewer houses were started than in January. Business failures in 1981 rose 45.2 percent from 1980. That is the highest since 1961.

For the first 4 weeks of 1982, business failures are 43 percent above the already high 1981 levels. When we look at the unemployment rate, it is threatening to break the 1975 post-war figures.

The question I have, is this, the administration's policy for reducing inflation—is this the price that we must pay in order to have inflation down, must this economy, with the things that I have just

mentioned, be at a complete standstill with small businesses, the housing industry, continuously going down.

Bankruptcies by small businesses, fewer housing starts, fewer jobs in the economy, but we still have members of the administration bragging about how the inflation rate is dropping and therefore that is why we must continue with these higher Federal deficits, that we must go along with the high unemployment rate.

From you, Mr. Stockman, what can you say to those who are unemployed whereas maybe I can relay that message back to those unemployed in my district, to those business persons filing bankruptcy? What do I say to those living in the rat-infested slums unfit for habitation about housing starts?

What message can I give to my people in my district, or what can you say to the American people who are unemployed and who are living in those rat-infested slums?

Mr. STOCKMAN. Mr. Ford, we have never believed that the way to combat inflation is to provoke a long and permanent and deep recession. We happen to be in a temporary recession right now, which was not desired or intended or necessarily a part of the policy, but events occurred, conditions accumulated, and the recession developed as many people anticipated for a long period of time.

They just didn't know when.

It seems to me that rather than dwell on that state of affairs that we have today, we ought to ask what can we do now in our capacity as Members of Congress, or the administration, to ensure that this recession is of the greatest brevity possible and that the recovery begins as early as possible and that the jobs that you are talking about are available and that the houses that you are talking about will get to be built.

The answer is that we have to take action this spring to get the deficit down so that interest rates will continue to come down and that the recovery can move forward as scheduled or planned later this year.

That is what I would tell you that you have to do.

Mr. FORD. Why do you and the administration submit to us a deficit of some $90 plus billion for fiscal year 1983 if you want to do something about bringing the deficit down? Why didn't you submit to us a balanced budget concept, a budget that would not have exceeded a deficit of $90 billion if you were sincere about it?

We have had many cuts in social programs.

Mr. STOCKMAN. Mr. Ford, the answer is, we submitted a budget in which we reduced the deficit in 1983 from $146 billion to $92 billion. We felt to do more would jeopardize things that were important. If we were to take the easy way out we could repeal and reverse the important tax incentives that will support and expand the recovery, create jobs, and help the very people you are talking about in the future. We believe that if we can hit the $92 billion mark we will have a deficit that is too high, that is burdensome, but that will not interfere in any substantial way with the economic recovery we are talking about.

Mr. FORD. President Reagan admitted in his state of the Union message that he had no plans to balance the budget on the backs of the American people and to look at some of the proposed budget

cuts with the social programs, Mr. Stockman, is a clear indication to me and other Americans that Mr. Reagan is planning to balance the budget at the expense of those who are in dire need of some of the vital social programs that have been in existence for so long in this country.

I would hate to see your office and this administration doing just what the President indicated in his state of the Union message that he had no plans of doing. That is, balancing the budget on the backs of the American people and especially the poor of this country.

Chairman ROSTENKOWSKI. Mr. Jenkins will inquire.

Mr. JENKINS. Thank you, Mr. Chairman.

As you know, I have tended to support the administration on the spending cut side. I agree with you that we really ought to look forward rather than constantly looking to blame someone for the predicament we are now in. But I also am concerned about the fact that we have to be realistic in some of the assumptions that we are making, not necessarily in the forecasts, but in what you are asking this committee and the Congress to do.

For instance, in the withholding of taxes and interest, we considered that during the Carter administration, and all the Republicans that I am aware of and the majority of the Democrats opposed it.

Do you really think we can pass that?

Mr. STOCKMAN. Mr. Jenkins, let me respond to that by saying I know precisely what you are getting at.

Let me show you the dilemma that you face. Do you propose a budget, thousands of decisions and details, based on the common denominator of what you think will pass; or, in the first instance, do you compose it of those things that you think are best, that are right, that are the things that need to be done?

Then you go into the political and legislative process and see where you come out.

I think Congress is better served by a budget document that represents good policy—at least as we conceive it—that will wait for the politics to work on it, as it always will, once the process starts, as happened last year.

Mr. JENKINS. Even those that are unrealistic?

Mr. STOCKMAN. In your view it is unrealistic. Maybe it is. Any item in this budget someone will label as unrealistic.

Had we used that criteria, we would have had no budget at all, except a huge deficit that would be intolerable to propose.

Chairman ROSTENKOWSKI. Will the gentleman yield?

Mr. JENKINS. Yes.

Chairman ROSTENKOWSKI. Mr. Stockman, in the bidding process that took place last year on the tax bill, would you say, that things got away from us a little bit?

Mr. STOCKMAN. That was my feeling at the time and it is my judgment still.

Chairman ROSTENKOWSKI. In other words, you would conclude—as certainly I have—that we did the country a great disservice by getting into the process of third party negotiations.

If we can avoid that this time, Mr. Stockman, I think you will have the cooperation of this committee. However, I honestly be-

lieve that we must find faith in somebody. It will be very difficult for us because my colleagues on my left participated more in the structure of the Ways and Means Committee tax bill than in the structure of the bill that finally passed the House of Representatives.

If anything comes from these hearings, it should be that we have learned that the bidding process serves no one any good. The President certainly had the victory. However, in the long run, I think, the economy has suffered for it.

Mr. JENKINS. Thank you, Mr. Chairman.

Let me ask you about another assumption you make. That is the $8 billion in 1983 on the OCS leasing to the oil companies.

Do you really think that is realistic? We have never had 50 percent of that amount.

Mr. STOCKMAN. Yes we have, Mr. Jenkins.

Mr. JENKINS. How much is it this past year?

Mr. STOCKMAN. In 1981 total offsetting receipts from royalties, rents and bonuses were about $10.1 billion.

This year the number is lower, but it is artificially depressed by two factors:

One, a large sale will occur in the latter part of 1982. The receipts will be recorded in 1983. That will have the effect of reducing 1982 receipts by $2.4 billion, increasing 1983 receipts by a like amount and creating the distortion.

Second, in 1983 we intend to lease acreage with an estimated hydrocarbon-bearing potential of 28 billion barrels compared to only 4 billion in 1982, with an estimated value twice the estimated value of 1982 acreage.

It is a much richer, fatter sale. Whether or not we get the full $18 billion is something America will determine, but on the basis of the methodologies that we use, that is the estimate that you come up with, given the acreage, given the value, and then given these accounting distortions.

Mr. JENKINS. I hope you are right. Everything that I have read in this field indicates that you are overly optimistic about the amount of income that you are going to get from that. I hope you are right.

Let me ask you about another thing. You say you are going to dispose of tens of millions of acres of Federal lands resulting in approximately $10 billion in income in the next 3 years.

I would assume you are going to have to give terms or else you are going to sell to the large corporations. I can't conceive of your being able to dispose of that amount of land in such a short period of time.

Do you see buyers out there ready and willing to buy?

Mr. STOCKMAN. I most certainly think so. We will be submitting a much more detailed plan to Congress to indicate the whole variety of areas. Remember, we are not just talking about land. We are talking about undeveloped land and developed land.

We are talking about office buildings, industrial facilities, unused defense facilities, the whole array in the inventory of real property and land that the Federal Government owns.

When you consider the size of it and the fact nothing has been done about it in the past, except simply to allow agencies to accu-

mulate property and never dispose of anything in return, we think these numbers are achievable and realistic.

It is going to take an all-out management effort to insure that it happens.

Mr. JENKINS. I don't disagree with your premise that you would like to dispose of some property, but I just do not believe that it is realistic to anticipate that in the middle of a recession——

Mr. STOCKMAN. We are not doing it, Mr. Jenkins, in the middle of a recession. The $10 billion you are talking about comes in 1984 and 1985. For 1983 we only anticipate $1 billion.

We have allowed about a 36-month period, in a much different economy, for that process.

Mr. JENKINS. "There's tens of millions of acres," that phrase you use in here—that bothers me. Surely, you are not going to sell recreational land or wilderness land. Where is that land?

Mr. STOCKMAN. If you take it on the 4 million in 1984, you see half of that coming from GSA sales of real property in developed or quasi-developed land held by Federal executive agencies. That is entirely talking about Government agencies and facilities totally outside the category of public lands. That is half.

The other $2 billion we believe could come out of two categories. The first category is lands held by the Forest Service that are singly used for forest only, that are very uneconomical and costly for the Forest Service to manage, and that could well be sold, as is, to private companies that want to develop these resources on their own.

The major gain or receipt would come from the sale of what are called 4-D lands in the BLM inventory.

There is a large and substantial holding of land that is either uneconomical to manage or near developed areas in small parcels or isolated tracts that would have great market value if sold to private developers who could use those parcels to complete projects or developments underway.

It is a very complicated business, but I think if you look at the whole spectrum of properties and assets and land that the Federal Government holds today, you would come to the conclusion that with a 2-year leadtime you could get $4 billion if you go about it aggressively. That is what we intend to do.

Chairman ROSTENKOWSKI. If there are no further questions, I want to thank you, Mr. Stockman, for joining us this morning. It has been most informative. I wish you well.

Mr. STOCKMAN. Thank you.

[Whereupon, at 12:30 p.m., the committee was recessed, to reconvene at 2 p.m.]

AFTERNOON SESSION

Chairman ROSTENKOWSKI. The committee will come to order.

I want to welcome the Secretary of the Treasury, the Honorable Don Regan. It is always a pleasure to have you with us. It has been almost a year. I hope that what we do this year will be done with a great deal more cooperation.

Mr. Secretary, last year the administration won some impressive political victories. With the Nation's hopes and good will running

your way, the White House chose—at least in my opinion—to bypass the legislative process and go another route to achieve your historic tax and spending cuts.

In my opinion, the tide of public confidence has now changed. The faith that the country once placed in the economic promises of this administration has turned to some doubt and certainly some fear. I fear that there are signs of economic weakness all around us. We were never told last year that the recession, high unemployment, and high interest rates were part of the Reagan economic plan. Yet this administration persists on its original course as if the economy was right on track.

In my opinion, the President's budget is a weak and unrealistic response to our economic mess. Business has shown no signs of confidence, and the general public is frightened about the future.

Mr. Secretary, we have asked you here today to give us a candid accounting of what went wrong with your original economic plan. We expect an even more candid appraisal of the country's real economic strength and our ability to pull out of what we consider an awful recession.

We both know that recovery rests on the Nation's confidence that Congress and the President can work out a common answer to the growing economic crisis. In the best of times, conflict between the President and the Congress wears hard on national policy. In times of great stress, conflict can only turn to stalemate. The victim of an inflexible White House or an unresponsive Congress is always the country. This legislative year is just beginning. We have the time and certainly the desire to confront the forces of recession. Congress, in my opinion, both sides of the aisle, is willing to walk the distance. I trust and hope that the administration, with your guidance and help, will walk with us.

Welcome, Mr. Secretary. We are ready to receive your statement.

STATEMENT OF HON. DONALD T. REGAN, SECRETARY OF THE TREASURY

Secretary REGAN. Thank you, Mr. Chairman.

Mr. Chairman, President Reagan's budget is a blueprint for growth and prosperity. It is a plan for reducing Federal spending and the tax burden. It is a plan for increasing the family budget. For the first time, we are asking the right people to tighten their belts: the Federal Government.

We have painstakingly gone through every time. All members of the Cabinet have met with the President on their programs. We have fashioned a budget that responds to the President's call for a New Federalism; it meets the complex needs of our society; and it reduces the rate of growth in Government.

This budget contains dramatic reductions in Government spending, yet it is important for people to know that we are not tearing down the house or ransacking the furniture. We are simply trying to stop the runaway growth of past Federal spending and restore a measure of commonsense to how we spend the people's money.

So let's take a quick look at how this budget was put together.

On the revenue side, we expect receipts totaling $666.1 billion for fiscal year 1983, of which $304.5 billion comes from individuals,

$65.3 billion from corporations, $225.5 billion from payroll taxes and the remainder from excises, Federal Reserve earnings, and miscellaneous taxes and fees.

More importantly, we have in place a sound long-run tax system for the 1980's, one that will promote rapid growth of income, savings, investment, and employment for years to come. That tax system, with a healthy economy, will generate as much revenue as Government should reasonably be allowed to spend.

However, the revenue picture has been heavily affected by two factors: the recession and the drop in inflation—one bitter pill and one piece of candy which together have significantly decreased revenue to the point of causing large deficits. The recession is temporary, and the decline in inflation is most welcome.

We, therefore, had to face some tough decisions about how to cover the costs of some very important Government programs—how to make up the difference between the $666.1 billion in revenues and the $757.6 billion in outlays—until the growing economy triggered by our reformed tax system brings growing revenues into line with restrained outlays.

Some have urged us to revoke the incentive-creating tax cuts already in place. The result would have been lower real growth for many years into the future. It would have involved a self-defeating major change in a permanent tax program to handle a temporary problem. That alternative was not seriously considered. Instead, we shall propose certain worthwhile tax reforms, upgrade our tax collection program, renew our efforts at controlling spending, and borrow to cover the remaining deficit.

Deficits are not good. They rob the private sector of financial and real resources needed for growth, and divert those resources into Government consumption. So do taxes. The root of the problem is the Federal spending which appropriates those real resources and then must find the means to pay for them in one way or another.

The budget deficit can and must be narrowed from the spending side. For too long, spending has been rising faster than the economy has grown. The economy can no longer support the burden. Some progress was made last year in reducing the runaway rate of growth in Federal non-defense spending. Further efforts will be required this year and into the future.

Insofar as spending is not reduced, it is preferable to close the remaining transitional recession deficits of the sort now being experienced by borrowing rather than by taxing. The funds are pulled from the private sector in either case, but taxes impose a larger cost in terms of reduced incentives for real growth.

We must continue to strive to reduce the deficit by curtailing spending and promoting real growth. The budget and outlook we are proposing take major steps toward closing that deficit over the next several years. In the interim, it can be handled in a nondisruptive fashion. Let me put the deficit into perspective.

The projected deficits, though some of them are at record dollar levels, are not unusual following a recession when measured as a percent of GNP. The first attached chart shows deficits as a percent of GNP since 1975.

On- and off-budget deficits were 3.6 and 4.5 percent of GNP in fiscal years 1975 and 1976, due largely to the 1974–75 recession.

Deficits are projected to be 3.8 percent and 3.1 percent of GNP in fiscal years 1982 and 1983, largely as a result of the current recession. There has been considerable concern that our projected deficits will put extreme pressure on credit markets and thus drive up interest rates. However, deficits do not cause high interest rates. The historical record shows no direct association of deficits and interest rates; the second chart shows that in years with large deficits, interest rates went down more than they went up. Interest rates are determined by the real rate of return on capital, the expected inflation rate, and a premium for risk. Although deficits could conceivably influence expected inflation and risk, this would not happen, according to the latest Federal Reserve Board report, unless they were accompanied by excessive money creation.

As you all know, this administration has adopted a policy of slow and steady growth in the money supply. We are in agreement with the Federal Reserve Board's fight against inflation and support their announced intentions to reduce money growth rates gradually from year to year. Although we are concerned about the effect of the volatility in money growth on interest rates, we intend to work closely with the Fed in order to reduce these unhealthy fluctuations.

The deficits will be manageable because of the growth of private sector savings, as shown in the third chart.

Private savings resulting from normal year-over-year growth and the Economic Recovery Tax Act will be several times greater than the total borrowing requirement of the Federal Government in 1983 and 1984 and thereafter.

The net additions to total private savings are larger than the rise in the deficit. They will produce crowding in rather than crowding out. This extra shot in the arm of capital markets will put downward pressure on interest rates. Even after financing the Federal deficit, there will be billions of additional dollars each year for private investment.

Normal year-to-year increases in savings exceed $40 billion each year. This will be supplemented by the additional personal savings and additional business retained earnings induced by the tax cuts.

Compared to 1981, private savings will be more than $60 billion higher in 1982, more than $170 billion higher in 1983, and more than $260 billion higher in 1984. Private savings was just under $480 billion in 1981. It will rise to more than $740 billion in 1984.

It has been lack of growth, more than anything else, that has been responsible for the current and projected deficit. As a rough rule of thumb, each time growth falls off by enough to produce a 1-percent increase in unemployment, the budget deficit widens by more than $25 billion. In fact, if we had grown fast enough over the past 4 years to get unemployment down below 6 percent, the current deficit would be roughly $75 billion lower.

Growth is the only way to balance the budget while promoting rising real income and employment. If the economy were growing at 4 to 5 percent per year in real terms, Federal revenues would be rising $30 to $35 billion per year in real terms, even under an indexed Tax Code without the windfall to the Federal Government from bracket creep. That is how fast the deficit would be falling in 1982 dollars if real spending were being held constant. We have not

asked for spending restraint of that magnitude, choosing a more gradual patn toward budget balance. After a slight dip in real outlays in fiscal year 1983, real outlays are projected to grow approximately one-third as fast as the economy in the following 4 years. However, we would be willing to look at further spending restraint if Congress wishes.

I would like to point out, very firmly, that any changes in the economic recovery program which reduce real growth will tend to worsen the budget picture. Changes which reduce individual or business savings by as much as or more than the deficit will only worsen the situation in the credit markets.

The budget is not merely an accounting document. One cannot simply take $1 billion out of column A and put it in column B. There are behavior changes and economic repercussions from tax and spending shifts which affect saving, investment, labor supply, income, and revenue. Very often, changes which may look good on paper will buy little or no progress toward solving a budget problem, especially compared to the economic cost to the whole Nation of the policy shift.

These facts should be kept clearly in mind as we look at the deficits in this budget.

As President Reagan points out in his budget message, our success in reducing inflation has reduced tax receipts. Over the next 5 years, we project a steady fall in inflation. Yet if normal GNP were just 2 percent higher each year, reflecting a continuation of higher inflation, Federal receipts would be enlarged by $353 billion over the 5 years as inflation and the progressive Tax Code pushed taxpayers into higher brackets. After allowing for inflated outlays, the budget deficit would be $38.5 billion lower in 1987.

In the past, this is how administrations and Congresses planned to balance the budget. We have a better plan. We intend to balance the budget through spending restraint, lower taxes, and higher real growth, not through inflation. In the short run, there will be substantial deficits, due primarily to the recession. However, we are confident that personal and business savings over the next few years will be adequate to finance both the projected deficits of the total government sector and a very rapid increase in real capital formation.

I realize that there has been concern over the apparent reluctance of business to plunge ahead with new investment. It is not surprising that some businessmen are holding back until they are certain it is safe to proceed. A lot of them are waiting for lower interest rates. Others are waiting to make certain that Congress will not make drastic changes in the Economic Recovery Tax Act so that they can plan with confidence. Nothing kills investment faster than uncertainty. Once these programs are resolved, the investment will be there.

On receipt proposals, while the administration is opposed to increasing statutory tax rates—rates which apply at the margin to taxpayers who work, save, and invest—at the same time it is committed to insuring that the tax system is run efficiently and fairly. Thus, while we will not support increases in marginal rates for taxpayers, we do propose changes in three areas:

One, an elimination of abuses and obsolete incentives within the system;

Two, a major effort to improve tax collection and enforcement; and

Three, enterprise zone tax incentives and miscellaneous efforts to charge users of various Federal programs for the benefits they receive.

We want to eliminate abuses and to remove obsolete incentives within the system. In many cases, abuses arise because the use of special types of financial arrangements or legal devices allow one taxpayer to pay a much lower tax than a similar taxpayer engaged in exactly the same activity. Through the accelerated cost recovery system and other provisions included in the Economic Recovery Tax Act of 1981, Congress, working with this administration, has lowered effective marginal tax rate on all types of business activity. We do not, however, support haphazard and arbitrary reductions in average tax rates for specific groups of taxpayers.

Eliminating tax abuses is entirely consistent with the administration's overall economic program. The abuses that we propose to eliminate generally do not provide desirable incentives. Even when they might affect marginal tax rates, the effect is so distorted and so difficult to disentangle from other effects that hardly any desirable effect is provided. Indeed, when a tax provision provides benefits only to a business or individual with special financial and legal arrangements, rather than to all taxpayers engaging in a similar activity, then it may end up subsidizing less efficient taxpayers with competent counsel over more efficient ones who rely on less competent legal and financial advice.

The tax revisions we are recommending are:

One, completed contract method of accounting;

Two, repeal of business energy tax credits;

Three, restricting tax-exempt bonds from private activities;

Four, legislative and regulatory changes to eliminate unwarranted tax benefits arising from modified coinsurance arrangements;

Next, capitalization of construction period interest and taxes by corporations and adoption of an alternative corporate minimum tax.

This administration proposes also that Congress join it in improving tax collection and enforcement insuring that taxes due the Government are in fact paid by taxpayers and paid on a timely basis necessary to the maintenance of a fair and workable tax system.

If nonpayment of taxes is allowed to go unchecked, it can slowly eat away at the well-being of our system that relies on voluntary compliance. If individuals instead are convinced of the certainty yet fairness of enforcement efforts and know that no taxpayer will be given preference in paying taxes and income is earned, then the system can work well. Taxpayers will comply honestly and support a system which they think is fairly administered.

However, if the Government fails to make adequate efforts at enforcement and adopt proper methods of administration, then that support will erode. Strengthened enforcement and improved tax collection are entirely consistent with the administration's economic program. Improved compliance and timely payment of tax owed

does not raise statutory tax rates and has almost no effect on the rate of return from savings and investment, but it does reduce the opportunities and benefits from underreporting income. Those who underpay their taxes indirectly raise the tax rates of those who report all of their income and pay their taxes on a timely basis.

It would be foolish to argue that efficient productive incentives are provided by our maintaining a system in which it is easier for some persons to underreport income or pay taxes later than others must. Our proposal is the collection and enforcement; and the collection area will be the following: withholding on interest and dividends, corporate income tax speed-up, and IRS staff increases.

While the administration is committed to a program of improved tax collection and enforcement, we are not wedded to these proposals only. We look forward to congressional input into this program and believe that your suggestions for improving collection and enforcement efforts will be vital to developing an overall bill. I feel confident that the resulting bill will be fair to the American people, yet at the same time will address in a forthright manner problems of compliance, administration, and timely payment of taxes.

Finally, the administration has proposed, and will continue to develop, initiatives to improve upon incentives in the economy to insure that direct beneficiaries and users of various governmental services are required to pay for some of these services and to make more rational and consistent the operation of existing programs. Within a day or two, we will be releasing comprehensive explanations of our proposals for major tax revisions and for improvement in tax collection and enforcement.

We are also preparing legislative drafts which we will send up as soon as they are completed. In my written testimony I have provided you with some brief details on each of our proposals.

In conclusion, Mr. Chairman, we have in place a tax system for the 1980's that will promote the growth of income, savings, investment, and employment for years to come. Eliminating the incentives just adopted by Congress and choosing instead to steadily increase tax rates would only be a return to the policies of the past—policies that have been tried and failed.

The budget deficits can and must be narrowed, but from the spending side, not the tax side. While the recession will cause substantial deficits in the short run, it is only higher real growth in the long run that will restore our Nation's health. Raising tax rates will only exacerbate our problems by lowering possible future growth.

While the administration is opposed to raising tax rates in general, it recognizes the need to insure that the tax system is run efficiently and fairly. We support a program to eliminate abuses and eliminate obsolete incentives, to make major improvements in tax collection and enforcement, to create enterprise zone tax incentives and to make efforts to charge users of various Federal programs for the benefits that they receive.

Let me now throw out a final challenge to those who might oppose the administration's tax program. I recognize that there are those who did not and do not support reductions in rates of tax for individuals and businesses, and I recognize that there are those

who will oppose the initiatives that we have presented to you today. What I find most incomprehensible, however, are those persons who can oppose both. At least in part, these individuals can only be proposing that an increase in tax rates on all taxpayers is a better means of raising revenues than eliminating abuses and obsolete incentives, or improving compliance and enforcement programs.

This type of choice, however, favors special interests, those who are able to engage in complex financial and legal arrangements, those who underreport their income, those who do not pay taxes on a timely basis and users of services who do not pay for the benefits they receive. Such favoritism is not warranted for two reasons: First, it is blatantly unfair to the taxpayer who willingly and honestly pays his fair share of the tax burden; and second, as a substitute for direct rate reductions, it provides much less incentive for restoring our Nation's economic health.

Mr. Chairman, I do not believe that most members of this committee will favor special interests over the average taxpayer. I invite each member of this committee to work with us on the proposals that I have outlined for you. Indeed, I look forward to your suggestions for ways to strengthen our efforts to eliminate abuses and obsolete incentives, to improve compliance and enforcement, to create enterprise zone incentives and to charge users of various Federal programs for the benefits that they receive.

[The prepared statement follows:]

STATEMENT BY
THE HONORABLE DONALD T. REGAN
SECRETARY OF THE TREASURY
BEFORE THE
HOUSE COMMITTEE ON WAYS AND MEANS
MONDAY, FEBRUARY 22, 1982

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We must continue to strive to reduce the deficit by curtailing spending and promoting real growth. The budget and outlook we are proposing take major steps toward closing that deficit over the next several years. In the interim, it can be handled in a nondisruptive fashion. Let me put the deficit into perspective.

The projected deficits, though some of them are at record dollar levels, are not unusual following a recession when measured as a percent of GNP. The first attached chart shows deficits as a percent of GNP since 1975.

On- and off-budget deficits were 3.6 and 4.5 percent of GNP in Fiscal Years 1975 and 1976, due largely to the 1974-1975 recession. Deficits are projected to be 3.8 percent and 3.1 percent of GNP in Fiscal Years 1982 and 1983, largely as a result of the current recession. There has been considerable concern that our projected deficits will put extreme pressure on credit markets and thus drive up interest rates. However, deficits do not cause high interest rates. The historical record shows no direct association of deficits and interest rates; the second chart shows that in years with large deficits, interest rates went down more than they went up. Interest rates are determined by the real rate of return on capital, the expected inflation rate, and a premium for risk. Although deficits could conceivably influence expected inflation and risk, this would not happen, according to the latest Federal Reserve Board report, unless they were accompanied by excessive money creation.

As you all know, this administration has adopted a policy of slow and steady growth in the money supply. We are in agreement with the Federal Reserve Board's fight against inflation and support their announced intentions to reduce money growth rates gradually from year to year. Although we are concerned about the affect of the volatility in money growth on interest rates, we intend to work closely with the Fed in order to reduce these unhealthy fluctuations.

The deficits will be manageable because of the growth of private sector saving, as shown in the third chart.

Private saving resulting from normal year-over-year growth and the Economic Recovery Tax Act will be several times greater than the total borrowing requirement of the Federal government in 1983 and 1984 and thereafter.

The net additions to total private saving are larger than the rise in the deficit. They will produce "crowding in" rather than "crowding out." This extra shot in the arm of capital markets will put downward pressure on interest rates. Even after financing the Federal deficit, there will be billions of additional dollars each year for private investment.

Normal year-to-year increases in saving exceed $40 billion each year. This will be supplemented by the additional personal savings and additional business retained earning induced by the tax cuts.

Compared to 1981, private saving will be more than $60 billion higher in 1982, more than $170 billion higher in 1983, and more than $260 billion higher in 1984. Private saving was just under $480 billion in 1981. It will rise to more than $740 billion in 1984.

It has been lack of growth, more than anything else, that has been responsible for the current and projected deficit. As a rough rule of thumb, each time growth falls off by enough to produce a 1 percent increase in unemployment, the budget deficit widens by more than $25 billion. In fact, if we had grown fast enough over the past four years to get unemployment down below 6 percent, the current deficit would be roughly $75 billion lower.

Growth is the only way to balance the budget while promoting rising real income and employment. If the economy were growing at 4 to 5 percent per year in real terms, Federal revenues would be rising $30 to $35 billion per year in real terms, even under an indexed tax code without the windfall to the Federal government from bracket creep. That is how fast the deficit would be falling in 1982 dollars if real spending were being held constant. We have not asked for spending restraint of that magnitude, choosing a more gradual path toward budget balance. After a slight dip in real outlays in FY 1983, real outlays are projected to grow between one-third and one-half as fast as the economy in the following four years. However, we would be willing to look at further spending restraint if Congress wishes.

I would like to point out, very firmly, that any changes in the economic recovery program which reduce real growth will tend to worsen the budget picture. Changes which reduce individual or business saving by as much as or more than the deficit will only worsen the situation in the credit markets.

The budget is not merely an accounting document. One cannot simply take a billion dollars out of column A and put it in column B. There are behavior changes and economic repercussions from tax and spending shifts which affect saving, investment, labor supply, income and revenue. Very often, changes which may look good on paper will buy little or no progress toward solving a budget problem, especially compared to the economic cost to the whole nation of the policy shift.

These facts should be kept clearly in mind as we look at the deficits in this budget.

As President Reagan points out in his Budget Message, our success in reducing inflation has reduced tax receipts. Over the next five years, we project a steady fall in inflation. Yet if nominal GNP growth were just 2 percent higher each year, reflecting a continuation of higher

inflation, Federal receipts would be enlarged by $353 billion over the five years as inflation and the progressive tax code pushed taxpayers into higher brackets. After allowing for inflated outlays, the budget deficit would be $38.5 billion lower in 1987.

In the past, this is how Administrations and Congresses planned to balance the budget. We have a better plan. We intend to balance the budget through spending restraint, lower taxes and higher real growth, not through inflation. In the short run, there will be substantial deficits, due primarily to the recession. However, we are confident that personal and business savings over the next few years will be adequate to finance both the projected deficits of the total government sector and a very rapid increase in real capital formation.

I realize that there has been concern over the apparent reluctance of business to plunge ahead with new investment. It is not suprising that some businessmen are holding back until they are certain it is safe to proceed. A lot of them are waiting for lower interest rates. Others are waiting to make certain that Congress will not make drastic changes in the Economic Recovery Tax Act so that they can plan with confidence. Nothing kills investment faster than uncertainty. Once these problems are resolved, the investment will be there.

RECEIPT PROPOSALS

While the Administration is opposed to increasing statutory tax rates -- rates which apply at the margin to taxpayers who work, save, and invest -- at the same time it is committed to insuring that the tax system is run efficiently and fairly. Thus, while we will not support increases in marginal rates for taxpayers, we do propose changes in three areas: 1) an elimination of abuses and obselete incentives within the system; 2) a major effort to improve tax collection and enforcement and 3) enterprise zone tax incentives and miscellaneous efforts to charge users of various Federal programs for the benefits they receive.

We want to eliminate abuses and to remove obsolete incentives within the system. In many cases, abuses arise because the use of special types of financial arrangements or legal devices allow one taxpayer to pay a much lower tax than a similar taxpayer engaged in exactly the same activity. Through the Accelerated Cost Recovery System (ACRS) and other provisions included in the Economic Recovery Tax Act of 1981, Congress, working with this Administration, has lowered effective marginal tax rate on all types of business activity. We do not, however, support haphazard and arbitrary reductions in average tax rates for specific groups of taxpayers.

Eliminating tax abuses is entirely consistent with the Admnistration's overall economic program. The abuses that we propose to eliminate generally do not provide desirable incentives. Even when they might affect marginal tax rates, the effect is so distorted and so difficult to disentangle from other effects that hardly any desirable incentive is provided. Indeed, when a tax provision provides benefits only to a business or individual with special financial and legal arrangements, rather than to all taxpayers engaging in a similar activity, then it may end up subsidizing less efficient taxpayers with competent counsel over more efficient ones who rely on less competent legal and financial advice.

This Administration proposes also that Congress join with it in improving tax collection and enforcement. Ensuring that taxes due the government are, in fact, paid by taxpayers and that they are paid on a timely basis is necessary to the maintenance of a fair and workable tax system. If nonpayment of taxes is allowed to go unchecked, it can slowly eat away at the well-being of our system that relies upon voluntary compliance. If individuals instead are convinced of the certainty yet fairness of enforcement efforts, and they know that no taxpayer will be given preference in paying tax as income is earned, then the system can work well. Taxpayers will comply honestly and support a system which they think is fairly administered. However, if the Government fails to make adequate efforts at enforcement and adopt proper methods of administration, then that support will erode.

Strengthened enforcement and improved tax collection are entirely consistent with the Administration's economic program. Improved compliance and timely payment of taxes owed does not raise statutory tax rates and has almost no effect on the rate of return from saving and investment, but it does reduce the opportunities and benefits from underreporting income.

Those who underpay their taxes indirectly raise the tax rates of those who report all of their income and pay their taxes on a timely basis. It would be foolish to argue that efficient productive incentives are provided by our maintaining a system in which it is easier for some persons to underreport income or to pay taxes later than others must.

While this Administration is committed to a program of improved tax collection and enforcement, we are not wedded only to the proposals presented in the budget. We look forward to Congressional input into this program and believe that your suggestions for improving collection and enforcement efforts will be vital to developing an overall bill. I feel confident that the resulting bill will be fair

to the American people, yet at the same time will address in a forthright manner problems of compliance, administration and timely payment of taxes.

Finally, the Administration has proposed a number of initiatives to improve upon incentives in the economy, to insure that direct beneficiaries and users of various Governmental services are required to pay for some of these services, and to make more rational and consistent the operation of existing programs. While the initiatives involve many issues besides tax policy, I want to discuss them briefly with you today because they also have an effect on receipts.

Within a day or two we will be releasing comprehensive explanations of our proposals for major tax revisions and for improvements in tax collection and enforcement. We are also preparing legislative drafts which we will send up as soon as they are completed. However, let me now provide you with some brief details on each of our proposals.

TAX REVISIONS

Completed Contract Method of Accounting

Current regulations allow contractors to defer tax on income from long-term contracts until the year that the contract is completed. This completed contract method of tax accounting permits full deferral of income reporting on progress payments received by the contractor throughout the term of the contract even though certain costs are currently deducted.

The completed contract method thus permits income to be deferred for tax purposes long after payments are received and long after income is deemed earned according to standard accounting practices. The use of the completed contract method has led to large and unintended tax benefits. For instance, many contractors, including virtually all in the defense and aerospace industries, can substantially reduce their tax liability through the use of the completed contract method. This is accomplished by deferring all income from a contract until the contract is completed while taking allowable deductions for indirect costs currently. In some cases the period of deferral can be as long as 10, 15 or even 20 years.

Because of inflation and the increasing size of new contracts, deductible costs on new contracts often exceed income to be recognized from old contracts in any one year. The result has been that many taxpayers, while enjoying substantial economic profits and reporting these profits to shareholders and creditors, have been reporting large losses for tax purposes. These tax losses may shelter other income

from taxation. In at least one case, the losses have been sufficient to eliminate the taxpayer's accumulated earnings and profits, enabling that taxpayer to make tax-free distributions to shareholders.

A particular problem resulting from the long-term contract accounting rules arises because certain construction contracts and contracts for the sale of heavy equipment include provisions for engineering or other assembly services to take place after delivery of parts and materials. Many taxpayers obtain additional deferral by maintaining that contracts are not complete until such services have been rendered. This is done even when full payment has been received upon delivery of parts and materials.

The Administration proposes legislation to disallow the use of the completed contract method of tax accounting, effective January 1, 1983. Taxpayers will be required to use either the percentage of completion method or the progress payment method of accounting for long-term contracts. The percentage of completion method permits current deductions for allowable costs but requires reporting income according to the percentage of the contract completed in the tax year. The progress payment method allocates costs to long-term contracts and defers their deduction until the taxpayer has a right to receive payment under the contract.

At the time the right to payment accrues, the taxpayer may deduct the total of the current and previously unclaimed costs allocated to a contract, up to the amount of the accrued payment. If the accrued payments exceed costs, the taxpayer would recognize such excess as income.

In addition, the Administration intends to amend the current completed contract regulations to require that most indirect costs (so-called period costs) be allocated to contracts rather than immediately expensed, and to clarify current rules regarding when contracts may be aggregated and when they must be severed in order to properly measure income.

The legislative and regulatory proposals would be effective for taxable years beginning after December 31, 1982. However, the legislative proposal provides that taxpayers may continue to use existing completed contract rules for contracts entered into on or before September 25, 1981, the date the Administration first announced its intention to change these rules. The regulatory proposal will similarly grandfather contracts entered into on or before September 25, 1981. Grandfathered contracts, however, may be affected by our corporate minimum tax as discussed below.

Repeal Business Energy Tax Credits

Under current law, businesses are allowed investment tax credits for energy property in addition to the regular investment tax credit. Also available are production tax credits and Industrial Development bond financing for certain energy sources. Current law further provides an excise tax exemption, or an equivalent tax credit, for gasohol. Some of these energy tax incentives expire at the end of 1982, but others extend through 1985 and beyond.

The original reasons for providing these tax incentives no longer apply today. At the time these incentives were proposed and enacted, price controls and allocations were in effect on both crude oil and natural gas, and there was substantial political resistance to decontrol. Prices of both oil and natural gas faced by consumers and received by producers were substantially below replacement costs, as reflected by the price of imported oil. Oil imports were growing at the same time that domestic consumption was being subsidized and domestic production discouraged.

Because of price controls, business firms and households had insufficient incentive to invest in energy-conserving capital or in alternative energy sources (other than oil or gas), or to use alternative fuels, such as fuels derived from alcohol, wood, or biomass. Therefore, some economic rationale may have existed for tax incentives for conservation and renewable energy.

Since enactment of the credits, however, crude oil prices have been decontrolled and partial decontrol of natural gas prices is being phased in. Whatever their original justification, the credits are no longer needed because most firms confront the true replacement cost of energy and therefore have sufficient incentive to invest in energy conservation and renewable energy and to purchase alternative fuels without targeted tax incentives.

The energy tax incentives distort the allocation of resources by encouraging firms to undertake investments that are uneconomic at current market prices and to purchase higher cost fuels when a lower cost substitute is available. As a result, these incentives divert workers, capital, and initiative from more productive uses elsewhere in the economy and lower the net productivity of the capital stock.

In general, tax incentives for specific investments fail to rely on markets to allocate resources efficiently. We believe that it is better to rely on the market, rather than Federal management, to determine patterns of energy use. The Administration's Accelerated Cost Recovery System (ACRS), enacted as part of the Economic Recovery Tax Act, has removed

tax impediments to business investment -- including investments now eligible for energy tax incentives -- without dictating firms' choices among investment alternatives.

Moreover, by reducing the cost of only some conservation measures, the energy tax incentives discourage other, potentially more efficient, approaches. Many new inventions and refinements in old technology are not covered by the subsidies, and therefore are at a disadvantage because the Federal government subsidizes the competition.

Effective January 1, 1983, the Administration proposes to repeal all business energy tax credits, the gasahol excise tax exemption, and special provisions allowing States and localities to issue tax-exempt industrial development bonds to finance low-head hydroelectric facilities and other energy property. Fuel production credits and incentives for alcohol fuel production will also be repealed. Transition rules will mitigate the effect of repeal on taxpayers who have relied on existing law.

Restrict Tax-exempt Bonds for Private Activities

Current law permits States and localities to issue tax-exempt revenue bonds for industrial development, housing, and other private activities. There is no requirement under current law that industrial development bonds (IDBs) serve a genuine public purpose. In addition, tax-exempt financing, combined with Accelerated Cost Recovery and the investment tax credit, can result in unwarranted tax benefits.

The volume of private purpose tax-exempt bonds has grown rapidly. More than $25 billion were issued in 1981, up from $8.5 billion five years earlier. Private purpose bonds accounted for 24 percent of the tax-exempt bond market in 1976 but rose to 48 percent in 1981. The largest growth has occurred in small-issue IDBs, which allow tax-exempt financing for any trade or business. Small-issue IDBs marketed in 1981 reached an estimated $10.5 billion, out of the total $25 billion of private purpose bonds. Continued growth in the use of tax-exempt bonds for private purposes is expected unless actions are taken to limit their use. The expansion of tax-exempt bonds for private purposes affects the market for tax-exempt securities as a whole. This raises the cost to State and local governments of financing traditional public services.

Many of the private activities using tax-exempt financing would not have received direct Federal or local government assistance. Small-issue IDBs have been used to finance such private activities as office buildings for doctors and lawyers, fast food franchises, recreational facilities, and nursing homes operated for profit. Access to tax-exempt financing is offered in almost all political

jurisdictions, either by State or local governments or by authorities acting on their behalf. These authorities are often established for the sole purpose of issuing tax-exempt revenue bonds for private entities and may serve to avoid local voter approval requirements.

Providing tax exemption for the interest on certain private purpose obligations may serve legitimate public purposes in some instances. Current law, however, does not require the showing of any genuine local public purpose. In fact, several issuing authorities have authorized tax-exempt bonds for facilities located outside of their own jurisdiction. A requirement that private purpose tax-exempt obligations be shown to serve the needs of the local community will improve the uses of the Federal tax benefit and will limit the volume of such obligations. This will reduce their impact on the market for traditional municipal bonds and the Federal government's revenue loss.

The availability of tax-exempt financing for exempt activities and other private purposes causes distortions in the allocation of capital resources. The ability to obtain a lower cost of borrowing for certain activities creates a bias in favor of investment in those activities. In effect, those favored activities are subsidized at the expense of other activities. Thus, the allocation of capital is based upon government decisions rather than upon its relative economic productivity.

Moreover, in combination with the accelerated cost recovery provided investment by the Economic Recovery Tax Act, tax-exempt financing results in unwarranted subsidy for many eligible borrowers. This combination of tax benefits completely eliminates the tax on income from certain investments and also provides tax shelter for income from other assets. "Double dipping" of this sort should not be allowed.

In contrast with other categories of private purpose tax-exempt bonds, exempt small issues may be used in limited dollar amounts for any type of investment in depreciable property or land. Large businesses presently are able to finance an unlimited number of facilities with small-issue IDB's because the dollar limits apply only within a single city or county. For example, one of the largest chains of retail stores in the country, has financed facilities in at least 100 localities, to the tune of $240 million since 1976. Many large firms are using small-issue IDB's even though they are able to raise funds readily in capital markets without a government subsidy or guarantee.

The Administration proposes that assets financed with tax-exempt bonds issued after 1982 must be depreciated using the straight-line method over extended recovery periods. In

addition, the tax exemption for private purpose bonds will be limited to those that are publicly approved by State or local governments and which, for bonds issued after 1985, receive a financial contribution or commitment from the local government. Small issue industrial development bonds will not be allowed for large businesses, which have capital expenditures exceeding $20 million over a six-year period. Additional requirements relating to information reporting of IDBs, registration, and arbitrage profits also will be imposed.

Modified Coinsurance

Many insurance companies have entered into modified coinsurance arrangements and have claimed substantial reductions in their tax liability. Such arrangements are designed principally for tax avoidance since little, if any, insurance risk is actually transferred between companies.

In form, modified coinsurance agreements involve the transfer of insurance risk between two companies. In substance, virtually no insurance risk is actually transferred. Although together they may be in the same financial and risk position after the transfer, their combined taxes rates are lowered substantially. Many policies reinsured under modified coinsurance involve little, if any, present insurance risk. Because there is no meaningful transfer of risk, there is generally no significant non-tax business purposes for most modified coinsurance agreements.

Modified coinsurance agrements are structured so that actual payment between the companies is a small percentage of the amount of income converted. This small charge represents the "coinsurer's" fee for entering into the agreement. The nominal amount charged indicates the absence of any significant transfer of risk or economic purpose under the modified coinsurance agreement.

The modified coinsurance provision of the Code was never intended to produce large tax benefits for insurance companies. The federal corporate income paid by the largest mutual life insurance companies fell by 35 percent from 1979 to 1980, and by more than 40 percent from 1980 to 1981. The primary reason for this reduction is modified coinsurance. In several cases, the effect was to nearly eliminate tax liability.

Through regulations and legislation the Administration proposes to eliminate the unintended tax benefits resulting from the use of modified coinsurance. In addition, the tax treatment of other forms of coinsurance will be changed to prevent insurance companies from obtaining similar unintended tax benefits. The legislative proposal applies to all

reinsurance agreements entered into after December 31, 1981.

Capitalization of Construction Period Interest and Taxes

Individual taxpayers must capitalize interest and taxes incurred during the construction of commercial and industrial buildings and deduct those costs over ten years. Under provisions of the Tax Reform Act of 1976, the write-off period for rental housing (other than low-income housing) is 8 years, but is scheduled to become 10 years by 1984. However, for corporations (other than subchapter S corporations and personal holding companies), the law permits immediate write-off of these costs. The substantial acceleration of cost recovery provided by the Economic Recovery Tax Act of 1981 makes it unnecessary to grant corporations an immediate deduction for a portion of construction costs.

It is a well-established financial and tax accounting principle that the costs of acquiring an asset, whether it is held for resale or for use in the production of goods and services for future sale, should be considered a capital cost, not a current cost, of earning income. Only when the asset itself is sold may the capitalized cost be recovered as a deduction from the sales proceeds in determining gain; or, if the asset is used by the owner to produce goods and services for sale, the capitalized cost may be recovered as deductions over a reasonable period as the asset is used.

Unlike most corporate taxpayers, individuals and partnerships are required to capitalize construction period interest and taxes other than those associated with low-income housing. These costs of acquiring assets are like other construction costs such as labor, materials, fees, and permits, all of which are capitalized and recovered when the real estate is sold or used to produce income. There is no economic policy or tax administration reason why corporations should not be subject to the same rules as individual taxpayers who construct commercial and other nonresidential buildings. Indeed, it is both economically inefficient and unfair to apply different sets of accounting rules to taxpayers according to their form of organization.

The Administration proposes that construction period interest and taxes incurred by corporations to develop non-residential real property after December 31, 1982 be capitalized. Costs will be recovered over 10 years. This proposal will not change the tax treatment of residential construction. The cost of commercial construction undertaken by corporations will be increased by a small amount, normally less than 2 percent.

Corporate Minimum Tax

Corporations currently must pay a minimum tax, in addition to regular income tax, equal to 15 percent of certain tax preferences. This "add-on" minimum tax is not limited to those corporations that pay very little or no regular income tax. It may apply to any corporation that has reduced its tax liability through the use of designated tax preferences.

Nonetheless, many corporations currently pay no Federal corporation income tax, despite reporting large profits to their shareholders. The proposed corporate minimum tax would tax "corporate profits," that is, regular taxable income plus certain special deductions, and would apply only to those corporations that pay very low regular rates of tax.

For corporations other than Subchapter S corporations and personal holding companies, the Administration proposes to repeal the add-on minimum tax, effective January 1, 1983, and to replace it with an alternative minimum tax. Corporations will be required to pay the greater of their regular income tax or an alternative tax equal to 15 percent of their alternative tax base. This alternative tax base equals regular taxable income plus certain tax preferences, less $50,000. The alternative tax base will include both preferences from the current minimum tax and a number of new preference items. Current preference items also in the alternative base are:

- Percentage depletion in excess of the year-end adjusted basis of the property,
- Accelerated depreciation on real property in excess of that allowable under the 15-year straight-line method,
- Amortization of certified pollution control facilities, and child care in excess of normally allowable depreciation,
- Reserves for losses on bad debts of financial institutions in excess of reserves allowable on the basis of their experience,

The alternative base will also include the following new preference items:

- Intangible drilling costs in excess of amounts allowable had they been amortized over 10 years,
- Mining exploration and development costs in excess of those allowable under a 10-year amortization schedule,

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- Lessor's leasing benefits which are in excess of net cash investment amortized on the straight-line basis over the term of a safe-harbor lease,

- Deductions for interest on debt to carry tax-exempt securities,

- Deferred DISC income,

- Shipping income deposited in capital construction funds or construction reserve funds,

- Amortization of motor carrier operating rights deductible under Section 266 of the Economic Recovery Tax Act of 1981,

- Original issue discount interest deductions in excess of amounts that would be deductible under a constant interest rate bond, and

- Current deductions of certain indirect costs incurred with respect to long-term contracts entered into before September 25, 1981.

The foreign tax credit is the only existing credit claimable against the alternative minimum tax. Investment tax credits which give no benefit due to the minimum tax can be carried forward.

We look forward to working with this Committee to develop a base for the corporate minimum tax that is reasonable and fair, yet insures that all profitable corporations pay their share of tax.

IMPROVED TAX COLLECTION AND ENFORCEMENT

Withholding on Interest and Dividends

Individuals who honestly report their interest and dividends pay more than their fair share of the total tax burden. Recovering known lost tax revenues by withholding -- where a reporting system is already largely in place -- is both an efficient and a sensible step to take.

Imposition of withholding on interest and dividends is a natural complement to the Economic Recovery Tax Act objective of reducing the tax burden on income from investment. Withholding offers an opportunity to increase tax revenues substantially without raising taxes on those citizens who carry their full share of the tax burden of this country.

While individuals are estimated to underreport wage income by only 2 to 3 percent, the comparable figure for

interest and dividend income is 9 to 16 percent. Even with the additional reporting requirements enacted in the Revenue Act of 1962, a number of taxpayers still fail to report and pay tax on around $20 billion of taxable dividends and interest.

As interest and dividends have increased as a share of individual incomes, the compliance problems of underreporting has also increased. In 1962, interest and dividends represented approximately 5.3 percent of adjusted gross income; by 1981, interest and dividends represented 8.4 percent of reported adjusted gross income -- an increase from $40 billion to $150 billion. At the same time, the portion of individuals' income represented by wages declined by at least an equivalent amount. As a result of this change in the composition of the Nation's income, taxpayer compliance overall has declined because a smaller portion of overall income is subject to withholding.

Unfortunately, information reporting is simply inadequate to reduce this shortfall. Much of the unreported interest and dividend income consists of relatively small amounts that millions of taxpayers simply neglect to report -- as a result of failure to maintain records, or other causes not amounting to fraud. Although the IRS matches a high proportion of the information returns filed, there are a number of reasons why the matching process cannot close the gap of unreported income. Many information returns contain inadequate or inaccurate information, with the result that matching is difficult or impossible. In the wage area, by contrast, the number of unprocessable information returns is much lower because taxpayers have an incentive to obtain proper credit for withheld taxes. It is extremely expensive for the IRS to use letters, phone calls, and personal visits to follow up taxpayers suspected of underreporting, especially when only small amounts of tax may be collected from each one.

The obvious failure of some taxpayers to report interest and dividend income diminishes public respect for the tax system, and jeopardizes our system of voluntary compliance. Moreover, past experience has proven that withholding is by far the most effective means of combatting noncompliance in the reporting of income.

Under the proposal, 5 percent of payments of taxable interest and dividends would be withheld. Nontaxable individuals filing exemption certificates and corporations would be exempt from withholding. Taxpayers aged 65 or older with a tax liability of $500 ($1,000 on a joint return) or less would also be exempt from withholding. This will exempt elderly couples earning less than $14,907 in 1983.

This withholding proposal differs significantly from

past withholding proposals. The problem of forced overwithholding, so prevalent in those past proposals, has been virtually eliminated by the low rate of withholding, the proposed exemption procedures, and the provision in ERTA which will allow workers to adjust wage withholding for any overwithholding that could occur. In addition, we must recognize that the system of reporting of interest and dividend income on forms 1099 is well established; new forms will be quite similar to the old forms, with an additional line for the amount of tax withheld. Costs to financial institutions thereby will be kept to a minimum. Indeed, my own experience as head of a large financial organization, along with many discussions with officers of our Nation's financial institutions, has convinced me that withholding is a sound and efficient means of increasing compliance.

Corporate Income Tax Payment Speedup

Corporations generally are required to pay at least 80 percent of their current year's tax liability in estimated payments due four times a year. The remaining liability is payable in two equal installments due on the 15th day of the 3rd and 6th months following the close of their taxable year. An exception to the estimated tax payments rules permits corporations to base their estimated tax payments on the full amount of their prior year's tax liability. For large corporations, the estimated payments must be at least 65 percent of their current year's liability (75 percent in 1983 and 80 percent thereafter).

To the extent feasible, taxes should be paid on a current basis. Given the ability of corporations to estimate their income on a monthly basis, there is no longer any reason to permit corporations to underpay their taxes by up to 20 percent. A 10 percent deviation is sufficient to reflect the uncertainties of intra-year estimates.

In order to collect corporate taxes on a more current basis, the Administration proposes, for tax years beginning after 1982, to increase the required estimated tax payment from 80 percent to 90 percent of the current year's liability, and to require that all remaining liability be paid in one payment on the 15th day of the 3rd month following the close of the tax year. In addition, large corporations making estimated tax payments based on prior year's liability will be required to pay at least 85 percent of their current year's liability in 1985 and 90 percent thereafter. All corporations with taxable incomes of less than $1 million in each of the three prior years will be exempt from this latter rule.

IRS Staff Increases

In order to improve the efficiency of enforcement and collection activities, the Administration proposes to increase the enforcement staff of the Internal Revenue Service by more than 5,000 persons.

Three thousand of these 5,000 new employees will be assigned to collecting delinquent taxes, 1,000 will concentrate on the identification of nonfilers who owe tax, and the remaining 1,000 will examine deficient returns and process appeals.

Although the vast majority of taxpayers voluntarily pay their correct tax on time, delinquent taxpayers currently owe the Treasury more than $20 billion in uncollected taxes. An estimated additional $70 billion in revenues are lost each year as a result of unreported income and improper deductions. A strengthening of Internal Revenue Service enforcement activities will generate increased government revenue and will improve the fairness of the tax system for all taxpayers. Public confidence in the equity of our tax laws is preserved only if the few who fail to pay their fair share are held accountable.

OTHER PROPOSALS AFFECTING RECEIPTS

Enterprise Zone Tax Incentives

Under current law, no special tax incentives are provided for the redevelopment of depressed areas. The Administration therefore proposes that beginning January 1, 1984, up to 25 small urban areas per year (not to exceed 75 in total) may be designated as "enterprise zones". Relief from Federal, State or local regulations, and special tax incentives designed to increase investment and employment will be provided businesses and individuals locating in these areas. These incentives will be applicable for a 20-year period. The Administration will be providing you with details on this proposal at a later date.

Miscellaneous Proposals

- Airport and airway trust fund taxes. Statutory authority for the airport and airway trust fund expired on September 30, 1980. The Administration proposes to reinstate statutory authority for the airport and airway trust fund effective July 1, 1982.

- Increases in passport and visa fees. The Administration has proposed an increase in passport fees from $15 to $30 effective April 1, 1982, and an

increase in immigrant visa fees from $25 to $100 effective March 1, 1982.

- o Change in railroad retirement system. The railroad retirement system provides coverage generally equivalent to a combination of social security and a multi-employer industry pension plan. Railroad employees and employers make contributions to railroad retirement that are generally equivalent to social security payroll taxes. Beginning October 1, 1982, the Administration proposes to extend full social security coverage to railroad workers; payroll taxes would be deposited directly in the social security trust funds. The Administration also proposes to return the rail industry's plan to the private sector.

- o Extension of highway trust fund taxes. Under current law, the 4 cents per gallon tax on gasoline and diesel fuels will decline to 1.5 cents per gallon on October 1, 1984. Several other taxes that are deposited in the highway trust fund will be reduced or will expire at the same time. The Administration proposes to extend these taxes at their present rate.

- o Extension of social security hospital insurance taxes to Federal employees. Most Federal civilian employees currently are exempt from social security taxes. The Administration proposes to require Federal employees to pay the employee portion of the social security hospital insurance tax effective January 1, 1983.

Technical Proposals

As soon as possible technical proposals will be submitted to further close tax loopholes and facilitate IRS collection and enforcement efforts.

CONCLUSION

We have in place a tax system for the 1980's that will promote the growth of income, savings, investment and employment for years to come. Eliminating the incentives just adopted by Congress and choosing instead to steadily increase tax rates would only be a return to the policies of the past -- policies that have been tried and failed.

The budget deficits can and must be narrowed, but from the spending side, not the tax side. While the recession will cause substantial deficits in the short run, it is only higher real growth in the long run that will restore our

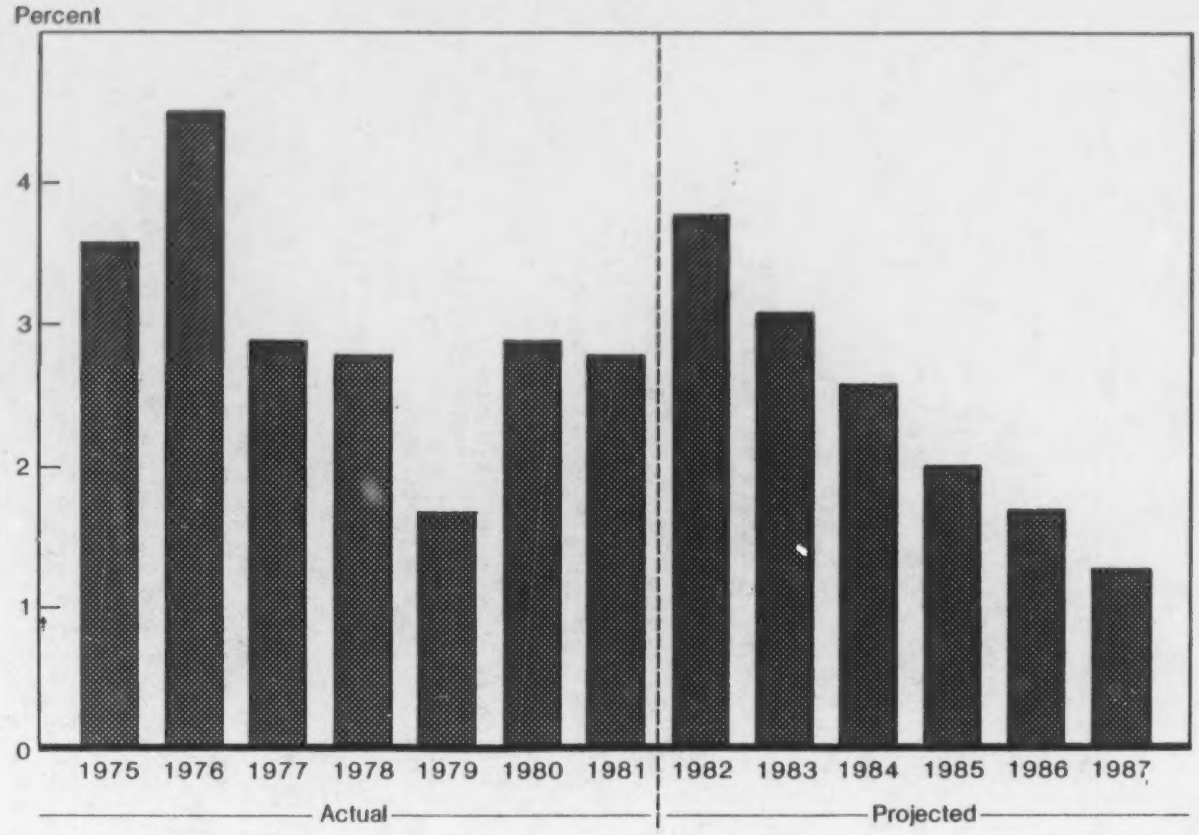
Nation's health. Raising tax rates will only exacerbate our problems by lowering possible future growth.

While the Administration is opposed to raising tax rates in general, it recognizes the need to insure that the tax system is run efficiently and fairly. We support a program to eliminate abuses and eliminate obsolete incentives, to make major improvements in tax collection and enforcement, to create enterprise zone tax incentives and to make efforts to charge users of various Federal programs for the benefits that they receive.

Let me throw out a final challenge to those who might oppose the Administration's tax program. I recognize that there are those who did not and do not support reductions in rates of tax for individuals and businesses, and I recognize that there are those who will oppose the initiatives that we have presented to you today. What I find most incomprehensible, however, are those persons who can oppose both. At least in part, these individuals can only be proposing that an increase in tax rates on all taxpayers is a better means of raising revenues than eliminating abuses and obsolete incentives, or improving compliance and enforcement programs. This type of choice, however, favors "special interests", those who are able to engage in complex financial and legal arrangements, those who underreport their income, those who do not pay taxes on a timely basis and users of services who do not pay for the benefits that they receive. Such favoritism is not warranted for two reasons: first, it is blatantly unfair to the taxpayer who willingly and honestly pays his fair share of the tax burden, and, second, as a substitute for direct rate reductions, it provides much less incentive for restoring our Nation's economic health.

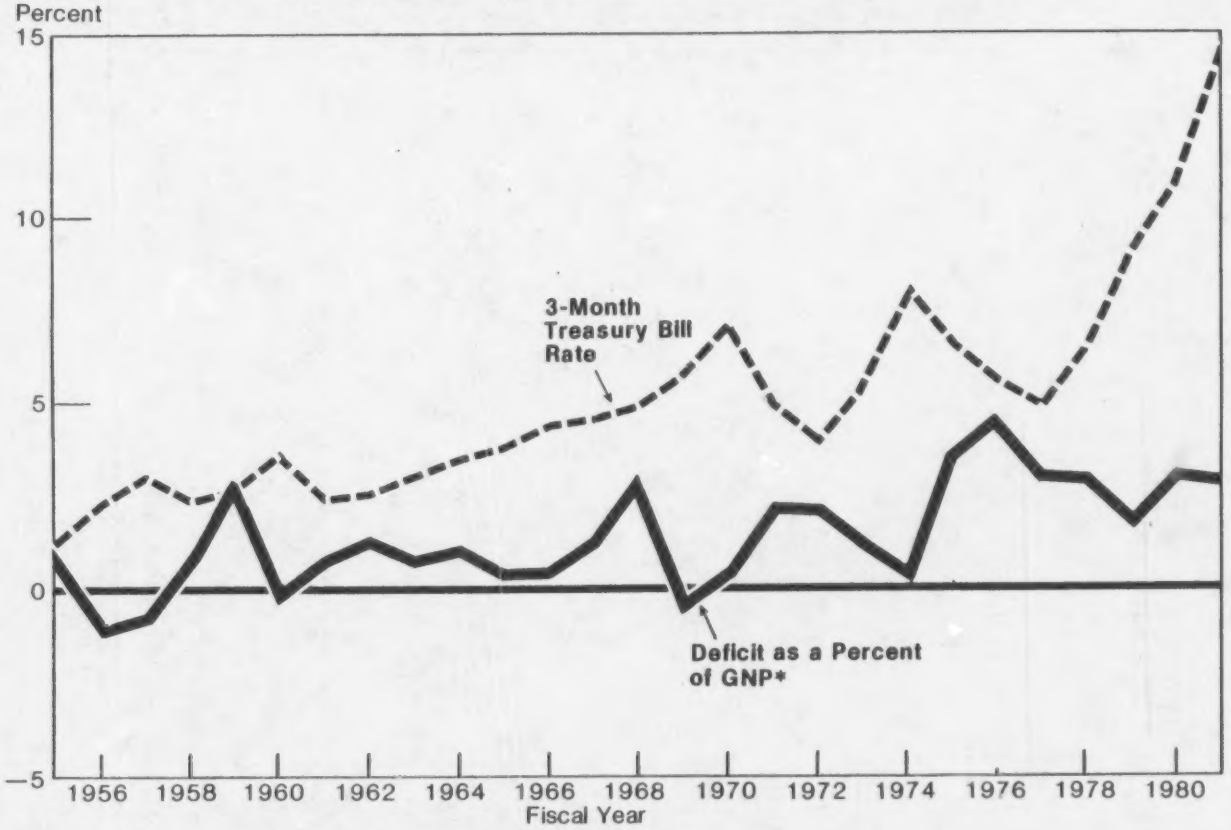
Mr. Chairman, I do not believe that most members of this Committee will favor special interests over the average taxpayer. I invite each member of this Committee to work with us on the proposals that I have outlined for you. Indeed, I look forward to your suggestions for ways to strengthen our efforts to eliminate abuses and obsolete incentives, to improve compliance and enforcement, to create enterprise zone incentives and to charge users of various Federal programs for the benefits that they receive.

Budget Deficits in Relation to GNP*



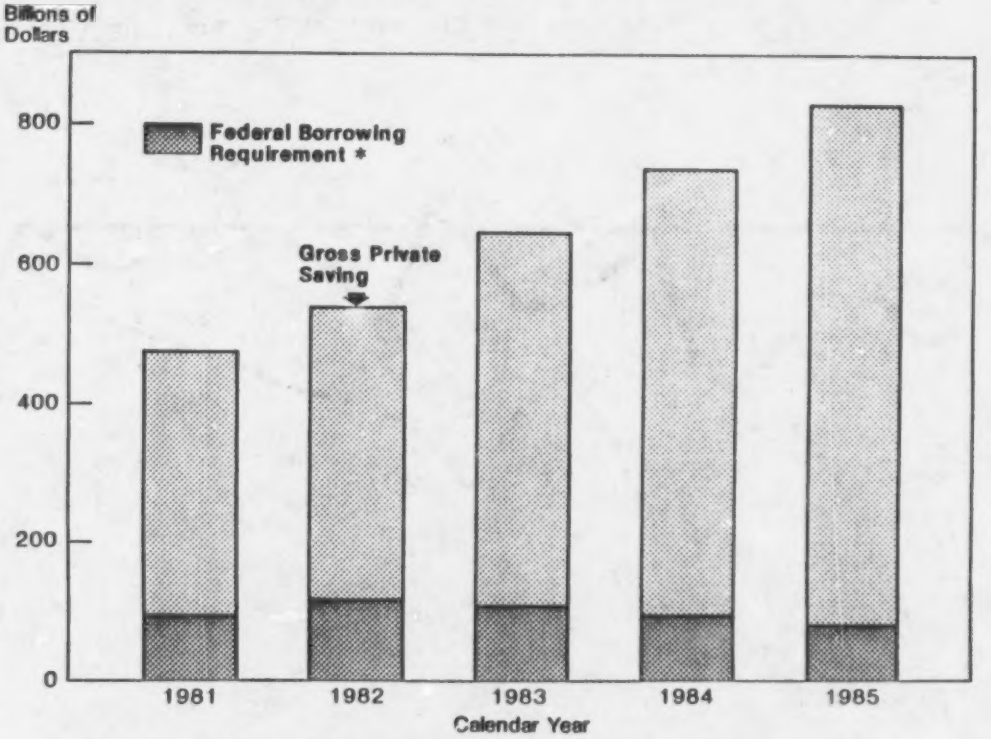
* On and off budget as percent of fiscal year GNP.

Interest Rates and the Relative Size of the Deficit



* Federal surplus or deficit includes off-budget items. Points below zero line represent surplus as percent of GNP, points above line a deficit.

Projected Borrowing Requirement in Relation to Private Saving



* Total calendar year budget deficit including off-budget entities.

Note: Saving flows do not reflect surpluses of state and local governments or inflows from abroad.

Chairman ROSTENKOWSKI. Thank you, Mr. Secretary.

Mr. Secretary, never in my wildest dreams did I feel that after the administration's program was enacted in August of last year, that the President would ask the Congress to raise taxes. Was that your judgment? Having reduced taxes in as large an amount as was done in the Tax Act last year, why did the President ask for an increase in taxes a month later?

Secretary REGAN. Mr. Chairman, there were several things that happened as you may recall at that particular time. The Congress was on its vacation period and at the same time we recognized that inflation was starting to come down, that as a result of that our receipts were going to be lower. We also knew the recession was coming on.

As a matter of fact, looking backward, it actually started in the month of July according to the accepted standards. Realizing we were going to have a revenue shortfall from what we had estimated for the Congress early on in the year, we recognized that we had to do something in order to turn the program around, that it was starting to unravel a lot quicker than we had thought it would as far as the effect of the economy on receipts was concerned.

Accordingly, we did come back with proposals for further cuts in the budget. You will recall at that time that we did make some proposals along the lines of some of those I have suggested to you today, although we never formally sent them up to the Congress.

Chairman ROSTENKOWSKI. Mr. Secretary, I assumed that immediately after the passage of the economic program of this administration that there would not be any more suggestions or requests from the President. Yet today, we are discussing the possibilities of increasing taxes, and further, reducing certain programs that members of this committee feel cannot stand any further cuts.

I just feel that it is very difficult for us to accept the rosy economic assumptions of an administration which comes back and asks for significant increases in taxes.

Taxes are taxes, Mr. Secretary. Business representatives testified before this committee last week that business taxes should not be raised but that the burden of any tax increase should be shouldered by individuals. I do not think that members of this committee will be very cooperative in increasing taxes on individuals, but rather will expend their energies on increasing taxes in the business area.

Naturally, I am concerned that we face an economic dilemma. We want to cooperate. However, I am also concerned with whether or not this administration will be big enough to accept legislative mixes that we could develop together—coming to some understanding between this committee and members of this administration.

Mr. Secretary, you are having problems right now on the other side of this building, on the Senate side. Your troops are not in march step this year as they were last year. I certainly hope that we can get together and discuss what direction should be taken. However, I find it very difficult to convince some of my colleagues about the merits of your economic proposals and your suggestions with respect to increasing taxes and spending cuts.

Secretary REGAN. Should I answer that, Mr. Chairman?

Chairman ROSTENKOWSKI. Please do.

Secretary REGAN. Let's try to get at it this way: First of all, regarding the so-called rosy scenario of last year—and as I recall, Mr. Pickle, it was just about 1 year ago that you christened that in this very Chamber.

Mr. PICKLE. I don't know that that was an original observation but that reference was made, yes.

Secretary REGAN. I recall sitting here listening to that.

May I also remind the chairman and you, Mr. Pickle, that no one else predicted the recession either. We have gone back very carefully to see whether any of the econometric forecasts, any of the blue chip consensus, anyone, at the time I was sitting here last year making that prediction, anyone else saying there would be a recession of the type that we have had. It is not that I am proud of what I said in missing the projection, but neither did anyone else make that projection. There is no evidence that anyone else projected that.

Chairman ROSTENKOWSKI. Mr. Secretary, we had some brilliant economists suggest that the tax cuts were too large. As a matter of fact, our colleagues on Wall Street cautioned us at the time.

Secretary REGAN. That had nothing to do with the recession.

Chairman ROSTENKOWSKI. Let me read from a statement that was made here last week by a predecessor of yours. "The budget proposals before you represent a program which is unbelievable, unworkable, and unjust. I must tell you in all frankness, therefore, that if I had been asked as Secretary of the Treasury to support and defend such a program, I would surely have seen no choice but to tender my resignation forthwith."

Mr. Blumenthal is a respected member of the business community. In no way, shape or form did he feel that he could support such a budget.

Secretary REGAN. If you recall—and I don't wish to get into a fight with my illustrious predecessor, but since he took a swing at me, at least I feel I could put up a little defense here—that during his tenure of office the deficits percentagewise were practically as large as they are now, with the exception of the recession year that we are in currently. He did not resign. So I just wonder about that.

Chairman ROSTENKOWSKI. He was talking about supporting the program.

Secretary REGAN. Taxes as a share of GNP increased under him, but will decrease under us. I wonder which is better for savings and incentives and the like, to increase taxes or not?

I have no difficulty in defending the President's program, his tax program nor his budget program. I do not intend to submit my resignation.

Chairman ROSTENKOWSKI. Mr. Secretary, do you find any more support from the financial community this year than you found last year? We don't see that. At least, not much enthusiasm has been brought to my attention. I am sure you would like to see more support from the financial community.

Secretary REGAN. I think that for the financial community, their problem right now is how soon are we going to get out of the recession? We have unusually high rates of interest. When are interest rates coming down? I think those are the two things bothering them. If they could see that our program will bring interest rates

down and that it will bring a recovery from this recession, I think they would be generally supportive of our program.

Chairman ROSTENKOWSKI. I hope you are right this time, Mr. Secretary. I just want to suggest to you that if there can be an administration/congressional mix with respect to the way taxes are written this year, I am sure that you will find that I, as chairman of this comittee and my colleagues on this committee are ready and willing to cooperate as long as the administration is not in cement on their positions.

Secretary REGAN. Let's not get into the analogies again this year, Mr. Chairman, but let me put it this way: If there are new ideas in the field that are good ideas, we would certainly like to look at them and to discuss them.

From the point of view of tampering with the President's program, as he said, he does not want his program tampered with. He thinks it is the right mix of incentives. Accordingly, he wants to stick with that program, but if there are other ideas, we would certainly take a look at them.

Chairman ROSTENKOWSKI. Thank you.

Mr. Pickle will inquire.

Mr. PICKLE. Thank you, Mr. Chairman.

Mr. Secretary, earlier this morning Mr. Stockman testified that most economists last year overestimated the real growth in GNP by some 50 to 65 percent. They were off base that much. It was unfortunate, but it happened. Yet 10 days ago the President submitted to the Congress a budget which, showed that the real growth in GNP for 1982 would be 0.2 percent and for the 1983 budget would be 5.2 percent.

That is a 5-percent growth. I find that rather startling to assume as fact. Is that another rosy scenario, or do you agree with Mr. Stockman?

Secretary REGAN. Mr. Pickle, the 5 percent, 5.2 percent growth coming out of a recession is not unusual. If you go back to the previous recession of 1974–75 and coming out of that in 1976—I am looking for a table I think I have that illustrates this. If you take the six initial recovery quarters from previous recessions and similar periods to what we expect to have now, 1975 to 1976, the growth was 5.3; 1970 to 1971, 5.6; 1961 to 1962, 6; 1958 to 1959, 5.7; and the average for all post-World War II recoveries, 5.6; we are saying the growth will be 5.2.

We are below the average.

Mr. PICKLE. I am essentially trying to establish for the record that you agree with the 1983–84 budget, that we will have a positive growth of 5.2 percent.

I want to establish that for the record again because I think you are pursuing a rosy scenario again in this field. I hope it is true, but it seems to me that it may be a little bold of you to give that to us again.

I want to ask your opinion on a subject you haven't testified about. I notice one of our colleagues is here today to just listen as an observer. That is the Senator from Florida, Mr. Pepper. He is very interested in savings and loans. In the Washington Post this morning it was estimated that a thousand S. & L.'s may have to

close within the next 60 days. Does the administration have a standby plan to help the savings and loans?

Secretary REGAN. Mr. Pickle, we have been monitoring the condition of the savings and loan industry for well over a year now. We have been using our good graces to work with the Federal Home Loan Bank Board in helping them to make certain that any savings and loan that is in trouble is either merged or helped in some fashion or another.

As a point of fact, last year—in 1981—only one savings and loan institution failed. That was in Chicago. It failed for an entirely different reason other than the economy.

Mr. PICKLE. There were a lot of mergers?

Secretary REGAN. There were quite a few mergers.

Mr. PICKLE. I don't know whether the figure this morning is correct or not. I know this city is full of savings and loan officials today. Every member here is being besieged by his home town savings and loan people. You are surely not indicating to me that this is not a likely possibility?

Secretary REGAN. What I am saying is, I don't think that number will fail for the simple reason that that study, the Brookings study, is based upon the same type of study that the Federal Home Loan Bank Board also does. As I recall their study indicates that if short-term interest rates average 15.5-percent through the end of 1983, about 1,000 institutions could fail.

We do not think that interest rates will stay up at 15.5 percent between now and 1983.

Mr. PICKLE. Do you have a standby plan for the saving of these savings and loan institutions?

Secretary REGAN. There is a plan already in place that is being used right now. Of course——

Mr. PICKLE. Do you have a new plan, and if you have one, can you make it known to us?

Secretary REGAN. At the present moment we don't see the need for a new plan. If interest rates come down as projected in the Federal budget, to an average 11.7 percent Treasury bill rate in 1982 and 10.5 percent in 1983, the estimate—on the same basis as Brookings could mean some 200 to 250 S. & L.'s would be in trouble in 1983, not 1,000, which there would be at a 15.5-percent rate of interest.

We think the problem can be handled with the current policies.

Mr. PICKLE. You do not have a plan now, no new plan?

Secretary REGAN. We do have a plan, Mr. Pickle. That is what I am telling you. We have a plan. It is being used. That is why those mergers were effected last year.

Mr. PICKLE. The plan you have is the same plan that is in operation now, no more?

Secretary REGAN. That is the plan that is in operation now.

Mr. PICKLE. Before my time goes, you proposed as deficit reductions $12.7 billion in tax increases, $25.9 billion in budget cuts, both entitlement and discretionary funds; $17 billion in management efficiency.

Mr. Secretary, it is not likely you are going to get all of these. Here again this may be wishful thinking on your part. I don't see how in the world you are going to get it all because we are divided

on both sides of the aisle, on such things as industrial development bonds and the minimum corporate tax. And your estimates on some items seem unrealistic—for example, you show an $8.4 billion increase in offshore leasing.

This is at a time when the bottom has dropped out of the oil market; prices are low. Who is going to invest in that kind of venture such that we will pick up an additional $8.4 billion?

Do you have a plan specifically for that?

Secretary REGAN. As you understand, that is not under Treasury. That comes under Secretary Watt. He does have these plans in effect, and he thinks that the sales will be there because his studies indicate that there are enough oil companies that would like to explore in those territories.

Mr. PICKLE. It just seems to me kind of odd that you collected $7.5 billion last year in a top year, a banner year, in offshore leasing.

Now, with the price of oil dropping, you are going to try to double that collection and get an additional $8.4 billion over and above what you got last year.

Mr. Secretary, that, along with a dozen other places, seems to me not realistic. I have a feeling you are chasing rabbits. We want to cooperate with you, but I would hope we could stand on firm ground.

Secretary REGAN. Look at the alternative, Mr. Pickle. If you don't go along with us on this, you come up with larger deficits which I know are anathema to you.

Mr. PICKLE. Mr. Secretary, I think we can meet you in some of these cuts and changes. I think we ought to continue in the direction you are going. You have to try to meet us too.

Chairman ROSTENKOWSKI. Mr. Gradison will inquire.

Mr. GRADISON. Thank you, Mr. Chairman.

Mr. Secretary, I would like to inquire with regard to a few specific points involving the corporate minimum tax.

Let me first start with the one which is listed, "deductions for interest on debt to carry tax-exempt securities."

Would this apply to banks?

Secretary REGAN. This would apply to banks.

Mr. GRADISON. Would it disallow the interest paid by banks on certificates of deposit and other interest-bearing accounts which were used to finance the banks' operations?

Secretary REGAN. Wait a minute. We are talking here about the borrowings by banks.

Mr. GRADISON. That is correct. If a bank borrows by the issuance of certificates of deposit or by the payment of interest on time accounts or NOW accounts, would that interest be disallowed to the extent it was applicable to the carrying of tax-exempt securities?

Secretary REGAN. The whole point here is, you would have to figure out what portion of that is being used to carry the exempt securities.

To the extent that that interest is being used to carry exempt securities, yes, that would go into preferences.

Mr. GRADISON. Mr. Secretary, is it possible this will be the death knell for the short-term tax-exempt market, since banks are the principal purchaser of short-term tax exempts?

Secretary REGAN. I doubt it, Mr. Gradison, because of the fact that they still, even though they don't get the interest to carry against the minimum tax, they still get the tax exemption of the interest itself on the short-term security.

So to that extent, they would still be able to carry these at a nice rate.

Mr. GRADISON. Would the interest be disallowed?

Secretary REGAN. The interest cost of carrying the security would be disallowed against the minimum tax but not the interest they would be getting on the short-term thing. That would be tax-exempt.

Mr. GRADISON. Tax exempt?

Secretary REGAN. Sure.

Mr. GRADISON. So the net benefit of carrying tax exempt securities would therefore be reduced?

Secretary REGAN. The net benefit would be reduced but not eliminated.

Mr. GRADISON. I would like to ask a question about the one before it on page 15 which reads "lessor's leasing benefits, which are in excess of net cash investment amortized on a straight-line investment over the term of a safe harbor lease"—would this——

Secretary REGAN. I am trying to get a copy of what you are reading from.

Mr. GRADISON. It has to do with the question of safe harbor leasing. I want to make sure I understand how this would apply.

In particular, would this have the effect of adding back the tax benefit for the lessor in all cases, or only in those cases of corporations which tend to have a relatively low average tax burden?

Secretary REGAN. It would apply, of course, only as a minimum tax, you understand. This is the preference item that would be put back into the alternative tax calculation. To the extent the minimum tax would not apply to a corporation, this particular provision would not apply at all.

Mr. GRADISON. Mr. Secretary, I believe under a statute we passed late last year, the Treasury was to receive, by the end of January, data with regard to such transactions which had been entered into with regard to the sale of tax benefits.

Could you give us any summary information on that study which would shed light on the extent to which this tax provision would have reduced the utilization or made unattractive the entering into of agreements that have taken place so far?

Secretary REGAN. At the present time we have analyzed only a very few of these returns. We have not been able to reach any conclusion from the examination of those returns as to what the whole thing is.

I am very hopeful that by certainly sometime in the month of March we will be able to come up with a definitive study on this.

Right now we have been overwhelmed by the amount of stuff that has come in.

I don't think it is fair to give that information at this particular moment.

Mr. GRADISON. Would you——

Chairman ROSTENKOWSKI. Will the gentleman yield?

Did you say that you would have those statistics available for us in the middle of March?

Secretary REGAN. Hopefully we can have some type of statistics.

Chairman ROSTENKOWSKI. That is very important, Mr. Secretary.

Secretary REGAN. We are working as fast as we can to get that data out. We realize the significance of what it means.

Mr. GRADISON. I would like, Mr. Secretary, to respectfully request that the data include some estimate, if possible, of the extent to which the application of your proposal with regard to the minimum tax would have reduced the utilization of that provision.

I think that would be very useful.

One other point: I hope you can work out—I have had great difficulty sorting out from the data so far with regard to these leases just what the interest earnings are to the lessor when you take into account the shifts of payments. I think there has been a lot of misleading information probably because it is so hard to interpret when there are different rates and different amounts going back and forth.

I think it would be extremely enlightening to know from the investor's point of view, from the lessor's point of view, just what rate of return they were obtaining or thought they were obtaining when they enered into these arrangements.

Secretary REGAN. Two quick things on that.

First of all, when we get the information to you, we won't have much detailed analysis because we won't have time to analyze the data we have been able to put together.

Over time we will be analyzing for those specific things. We will do that as quickly as we can. I suspect we will come up with varying rates of return, depending upon the deals that have been structured.

Mr. GRADISON. I would expect so. It would be useful to see whether those rates of return vary with the size of the deal, the credit of the institution, or even when they were entered into. It wouldn't surprise me if the earlier ones carried higher returns before competitors got into the business.

Secretary REGAN. That is entirely possible and probable.

Mr. GRADISON. I would only close, Mr. Chairman, by suggesting until we have this data in a useful way it will be hard to act upon this proposal without shooting in the dark.

Thank you, Mr. Chairman.

Thank you, Mr. Secretary.

Chairman ROSTENKOWSKI. Mr. Gradison, the middle of March is not inconsistent with the schedule that we have worked out. If we could get those returns and information by the middle of March, that would be very helpful. Do you wish to comment, Mr. Secretary?

Secretary REGAN. I just wanted to say that in talking with one of my associates, he says by the middle of March we will have the data for you, but not the analyses—I shouldn't promise you a quick analysis.

Chairman ROSTENKOWSKI. As long as we get the data in the middle of March.

Mr. Rangel will inquire.

Mr. RANGEL. Could we leave this for a moment and discuss briefly the administration's policy with respect to tax exemption for schools that practice racial discrimination?

Due to a recent court case we in the Congress are very anxious to find out what your present thinking is.

Secretary REGAN. At the present time Mr. Rangel, in view of the recent decision here in Washington, we have—are under court order and we will comply with that court order not to make either the Bob Jones University nor the Goldsboro School—let them have an exemption. We are now trying to figure out—and, sir, I remind you I am not a lawyer—what the next legal step is.

Mr. RANGEL. If I had known that earlier, that would have explained all the reasons why we are where we are now.

Secretary REGAN. I don't know whether to take that as good or bad.

Anyway, Mr. Rangel, in answer to your question—by "we" I mean the Justice Department and Treasury—are trying to figure out the next step at this particular moment.

Mr. RANGEL. The next step, if we can find a lawyer, is to try to get back to the status quo. There is nothing wrong with leaving it in the hands of the Supreme Court. Members of this committee are very anxious publicly and privately not to polarize and not to tear this country apart just because somebody made a mistake.

We cannot do this if people are going to lock themselves in cement. Now, we find ourselves with qualified private schools being denied exemptions under the court order.

I hope there is some timeframe because I don't think we should wait for the courts to respond since the initial action was taken by the executive branch and thrown into a legislative court, and it is clear the House and the Senate really do not believe there is a need for legislation.

I think the longer it draws out, the more difficult it becomes for our Nation. Our chairman is very anxious to work with whatever lawyers you have, preferably the lawyers from IRS, but we will see what happens.

The enterprise zones—since you have been in office, I have been allowed to believe that the only thing I could look forward to was a substitute for the social programs—health, education, and housing would be the enterprise zone programs.

You have two of my colleagues out there on limbs, Robert Garcia and Jack Kemp. They have now reported they have no idea whether you are talking about their bill or something entirely different which contains changes in the minimum wages along with some changes in the occupational safety regulations.

Could you share with us now what the administration really means when it talks about enterprise zones?

Secretary REGAN. What we are attempting to do, as you know, is set up initially at least 25 zones in various cities and towns, because the rural constituencies also want in on whatever we are doing here. That is in an attempt to see what it takes to get these zones revitalized.

Mr. RANGEL. I know the concepts, Mr. Secretary.

Secretary REGAN. From the point of view of what we are trying to do specifically, the Congress and the administration last year, in ACRS and the like, made things very attractive to business.

We have to see now what else we can do to make it even more attractive. We are talking in specific terms about such things as the minimum wage; we are talking about tax benefits; in addition, tax credits for hiring the disadvantaged; things of that nature.

The whole package is being put together very carefully, because each time we proceed in one way, we are told by somebody else that will not work.

We have had in task forces on this, mayors of cities who disagree among themselves as to what will work in their city or not.

It is, to put it mildly, a little baffling to try to see what actually will put people to work.

We had somebody in the Bronx just the other day. He has a factory in the Bronx. He told us we should get out of his way, the Federal Government is too much in his way. He wants more the free enterprise road.

Others say no, you have to make low-cost loans available and things of that nature.

Mr. RANGEL. Mr. Secretary, I know how complex the issue is, but it is just a little unfair for those of us who come from communities with such high unemployment to constantly hear the administration refer to a program that is supposed to assist us in dealing with that when, in fact, we have had nothing in writing so we can understand the problems which you are facing at the White House in coming up with a program.

When we heard that you were writing off Kemp/Garcia, and both are now saying that you have stepped away from their bill. This really allows for a lot of hopelessness and despair in trying to understand what programs the administration has for dealing with the unemployed, and the unemployable.

We know where the cuts are, but some people never believed you intended to come up with enterprise zones because of the cost which is consistent with other parts of the so-called recovery package. But it doesn't bother me that politically you are not coming up with anything concerning enterprise zones, but it certainly bothers a lot of Americans that had hoped that whether you could work out all the details or not, that you could put something down in writing. I have seen nothing.

Secretary REGAN. Mr. Rangel, I think I can assure you in 30 to 45 days you will see something in writing. We have not kissed Garcia nor Kemp off. We intend to work with them in coming up with a complete package.

We want to make sure that it is a doable package and not just pie in the sky when we come up with it. That is why we have been trying to work through the mayors and the like, showing it to them, discussing our proposals with them.

As soon as we can get some indications of what will fly, then we will be up with the actual legislation.

Mr. RANGEL. Thirty days is something we haven't heard before. Thank you.

Chairman ROSTENKOWSKI. Mr. Stark will inquire.

Mr. STARK. Thank you, Mr. Chairman.

Welcome, Mr. Secretary.

Along with the program of new federalism that the administration is proposing, it is my understanding simply stated you plan to turn social programs over to the States and certain revenue sources to help them pay for them.

Is that a fair statement?

Secretary REGAN. That is correct, Mr. Stark.

Mr. STARK. This is a rather parochial issue, but I am wondering how this squares with your recent decision to intervene in the U.S. Supreme Court case that restricts the State's ability to tax?

You filed a friend of the court brief in the *Chicago Bridge and Iron* case, or the Justice Department has—in the case of California, I think it would cost us $500 million in reduced taxes. In the case of Illinois I think it is $75 million in reduced taxes. How does that square with the new federalism? How can you give us programs and say you want us to be more independent and manage, yet at the same time restrict our ability to tax companies that voluntarily do business in our State?

Secretary REGAN. I think you have apples and oranges here, Mr. Stark. Turning back the programs and the moneys along with it, the new federalism program is one concept that has long been a principle of this administration, to put these programs where they can be—at least in our opinion—administered better than they are currently.

Along with that, the revenues. As you know, the Governors are here now. This is a subject we are talking with them about right now.

Mr. STARK. Why shouldn't the Governors be allowed to tax corporations as you see fit?

Secretary REGAN. Again you come into something here which is a constitutional issue. You have an international company——

Mr. STARK. Why shouldn't the Supreme Court decide that if it is a constitutional issue?

Secretary REGAN. That is what we are doing, that is why we entered, in order to make certain the Supreme Court does get this issue, to make certain as to what it is.

Mr. STARK. I gathered you are coming down on one side or the other and are not willing to let the court decide this just on the merits.

Secretary REGAN. Oh, no. We just thought we would give the court the benefit of our thinking on it.

Mr. STARK. Which is that States should be restricted in the way States tax corporations?

Secretary REGAN. That is our view of the Constitution.

Mr. STARK. They haven't spoken on that issue yet.

You and I are not lawyers. It would seem for us to make constitutional decisions before the Supreme Court acts is a little presumptuous on both sides.

You are supporting withholding on interest and dividends. How do you feel about withholding on the earnings of independent contractors or withholding on gambling earnings?

Secretary REGAN. That is a subject we are looking into from the point of view of the underground economy and the like.

Mr. STARK. Don't you think we should withhold on them?

Secretary REGAN. I would want more facts on that before I make a decision. On some betting now, on large bets and the like, withholding is done. It is on smaller wagers and the like where withholding is not at the current moment.

As far as independent contractors, it depends upon what type you mean. Going into domestics, things of that nature, as you know, withholding is now supposed to be done on domestics as far as social security is concerned.

Mr. STARK. So it wouldn't be much harder——

Secretary REGAN. We don't know. We are looking at that. As far as withholding itself, I think that is an idea whose time has come. There are a lot on this committee and a lot of others in Washington who disagree with me on this. I think it is an idea whose time has finally come.

Mr. STARK. As a former investment banker, if you were in fact sure that interest rates are coming down as you stated they are today, wouldn't you borrow short knowing that interest rates are coming down as you told us you know they are coming down?

Secretary REGAN. That is a question of marketability and marketing. You have to remember that what we are trying to do here, we have at the present time close to a trillion dollars in debt in the United States.

Mr. STARK. Why go long if they are coming down?

Secretary REGAN. We have to finance that day in and day out. At the current moment the average life is about 4 years.

Mr. STARK. Your new issues have been 5 years, the recent issues. Why not hold those for a year?

Why don't you save the taxpayers a lot of money that way?

Secretary REGAN. What if we ruin the market in so doing?

Mr. STARK. You have already done that. There is no long-term investment at all. There are no mortgages. There is no long-term investment.

Secretary REGAN. We are talking about apples and oranges. I am talking about the long-term market for government securities.

Mr. STARK. You don't think that has an effect on corporate bonds and municipal bonds?

Secretary REGAN. I didn't say that. I said the market plays itself.

Mr. STARK. You say in your testimony you realize there is a concern over the reluctance of business to plunge ahead with new investment. You go on in that paragraph to say nothing kills investment faster than uncertainty.

On the record of uncertainty, I note that in May 1981, you said the fact remains you are opposed to indexing, although if we suggested postponing indexing you opposed that now.

In October 1981 you said we have no intention of retreating from these absolutely fundamental goals which is keeping the deficit in the range of $42.5 billion.

Yet now you are telling us that in January, in the administration's budget message, that deficits are not important.

Then in October—September 1981, you told the House Budget Committee that the deficit is under control.

Now you suggest that perhaps it isn't.

In February 1982, you told the National Press Club that the reason the larger than expected deficits were here was because you

were a victim of your own success because inflation had come down when, in fact, you predicted inflation to be 9.9 and it ended up 10.3.

So here you have a consistent pattern of saying one thing in May and another thing in December and one thing in September and another thing in January; and one thing in October and another thing.

Don't you suppose that maybe the major part of the uncertainty is coming from the administration itself?

Secretary REGAN. Oh, I doubt that, considering the remarks of some of the Congressmen I have heard. I would say that the uncertainty that is in the financial world is uncertainty regarding exactly where are we going here in Washington.

Are we going to actually have a program?

Mr. STARK. Are deficits important or aren't they?

Secretary REGAN. Deficits are very important, as I said in my opening remarks. They are very important. We are trying to get them down.

Chairman ROSTENKOWSKI. The time of the gentleman has expired.

Mr. Moore will inquire.

Mr. MOORE. No questions, Mr. Chairman. Thank you.

Chairman ROSTENKOWSKI. Mr. Vander Jagt will inquire.

Mr. VANDER JAGT. Welcome to the committee, Mr. Secretary. We are glad to have you here. Thank you for your testimony.

I yield the balance of my time.

Chairman ROSTENKOWSKI. Mr. Downey will inquire.

Mr. DOWNEY. Thank you, Mr. Chairman.

Mr. Secretary, last year if you will recall, we had a heated interchange when I called your economic assumptions hallucinogenic. Of course, that is incorrect; the term is hallucinatory. I find no reason to alter that view of your projections for 1983 and, frankly, as I read this statement, I find it other worldly. It is inconceivable to me that we are living and working in the same city.

Have you noticed the fact that we are, with almost 9 percent of our people unemployed, that we have a 43-percent increase in business failures; that just last week the Commerce Department reported that the output in January fell by 3 percent, the largest decline in production for 1 month since January 1975? These things have not escaped your attention, have they?

Secretary REGAN. No, Mr. Downey.

Mr. DOWNEY. I would like to know, Mr. Secretary, when can we expect this economy to turn around? When can we expect the recession to start abating? It seems to me we are hearing again different periods of time. The President said that he didn't want to be pinned to a date, but he thought sometime in the summer.

Mr. Stockman said the summer or the fall. You, before the Press Club in February, said it would be in the spring sometime. When are we going to recover, Mr. Secretary?

Secretary REGAN. What do you mean by recover?

Mr. DOWNEY. When are we going to see a positive rate of growth in the gross national product?

Secretary REGAN. I think in the second quarter of 1982.

Mr. DOWNEY. That is the first period of time that we will begin to come out of the recession?

Secretary REGAN. In answering your definition of recovery, that is a positive growth.

Mr. DOWNEY. I would like to ask you some questions with respect to balancing the budget, since apparently it is less of an issue these days than it has been in the past. There has always been an article of faith among Republicans that deficits caused—high deficits caused higher interest rates and part of the reasons we had these problems. I am confident now that you have told me there is no relationship between high deficits and high interest rates.

What concerns me is that the CBO in projecting the outlay figures for 1983, 1984, 1985, and 1986 seem to indicate that outlays will be continuing to rise faster than revenues and that despite the recovery. Because many of the CBO figures are premised on a recovery economy. We are going to continue to run high deficits and we, in fact, are not going to see a balanced budget. The difference that you pointed out, that periods of time where we have had recoveries, high percentage rates of growth after a recession are not going to happen because despite increased savings, the deficit that this Government runs in a growing economy will still be large.

How are we going to provide incentives and investment for people, Mr. Secretary, if we sustain in a recovery high rates of deficit spending?

Secretary REGAN. I will try to make my answer brief, Mr. Downey. That is a complicated question.

First of all, the CBO projections, I believe, are before policy changes. That is, any further cuts in the budget or any further tax increases through the closing of loopholes and better collection methods as I have suggested.

If you notice this chart that accompanies my testimony to you, you will notice very clearly over the period from 19—well, let's see, this goes on from 1958 to 1980, that whenever there are large deficits, the rate of interest does not increase.

As deficits decline, interest rates can go up. As deficits increase, interest rates can go up, and vice versa. So there is no real connection between the two.

As far as savings are concerned, if you will notice this other chart that we have for you——

Mr. DOWNEY. Mine is not in color.

Secretary REGAN. Mine is so you could see it better from this distance. As the pool of savings increases due to the tax cuts, due to the incentives we have, both business and individual, and the amount of borrowings tends to stay steady and then decline, one as a percentage of the other continues down.

So rather than having crowding out, there can be actually a crowding in because we will have enough savings for both the business sector and for the Government needs. As long as we don't have to borrow from the Federal Reserve—that is to monetize our debt—we actually come out better off this way than we would by raising taxes.

Mr. DOWNEY. Mr. Secretary, let me ask you some questions about the chart here. Is it fair to assume—the chart you showed me before about interest rates—is it fair to assume that we have never had a period of time where we have pursued basically—where we are going to have large deficits and also tight money? Is there any-

thing in your chart that indicates, for instance, a period of time where the Federal Reserve wanted to keep monetary growth at a low level?

It seems to me we are entering something of a new era with constructive budget deficits at the same time that we have tight money. Isn't that different than what has happened in the past?

Secretary REGAN. No; I don't think so. I think if you take a look at the deficits in 1974 and 1975, and at the money growth rate, the rate of increase then was somewhat similar to what we hope it will be this year; that is between 5 and 6 percent.

So I think there are times in the past when we have had a rate of growth in the money supply that is down and at the same time interest rates have come down also.

Mr. DOWNEY. So this is not in any way different than, let's say, recent history, what is happening today?

Secretary REGAN. I would say it is well within the realm of what has happened before; yes.

Mr. DOWNEY. Thank you, Mr. Secretary.

Chairman ROSTENKOWSKI. Mr. Frenzel will inquire.

Mr. FRENZEL. Thank you, Mr. Chairman.

Thank you, Mr. Secretary, for your testimony. I have some interest in your proposal on page 12 dealing with the modified coinsurance feature. I am not going to place direct questions to you. I do have a number of questions which I worked on with Mr. Holland who has a particular interest in this area.

I am going to ask the Chairman for unanimous consent to put the questions in the record so that they might be responded to by the Secretary for the record.

Chairman ROSTENKOWSKI. Without objection, so ordered.

[See p. 320 for questions and answers.]

Mr. FRENZEL. I understand Mr. Jenkins is interested in this, too. He may wish to put a few of them. I want to be sure we are covered.

Secretary REGAN. This is with regard to modified company insurance?

Mr. FRENZEL. That is correct.

Secretary REGAN. We have been in touch with several of the life insurance company groups regarding this to get their input.

Mr. FRENZEL. Good. I can assure you we have, too. Proceeding to page 15, which is your suggestion for the corporate minimum tax, there are a couple of items in there that I do not understand the effect of, because this is the first time I have seen a listing of what is going to be included in the preference income.

One of the things that disturbs me is that you have included in there deferred DISC income. We set up the DISC as an export incentive. It doesn't work very well, I think most of us would agree. There are some difficulties with it conforming to GATT regulations.

Nevertheless, it is the only incentive we have for exporting. Now you come along and step on it. How do you justify that kind of policy?

Secretary REGAN. You understand we are only stepping on it to the extent it might come under a minimum tax. A corporation that pays a normal tax rate would not get below the minimum. The al-

ternative minimum tax would not apply. They would still be eligible to use DISC; and to the extent DISC is thrown into the alternative minimum tax base, it becomes one of the many preference items in the base and the tax rate is only 15 percent of that base.

Mr. FRENZEL. I would agree but this is kind of a tough year. You are probably going to find a lot of corporations reporting relatively low income rates.

Secretary REGAN. Surprisingly there are quite a few that are, particularly a lot of the larger overseas corporations have been doing reasonably well. Now, let me say this about our entire list. As we said in our concluding paragraph there—and this is in reply to something the chairman said earlier—we look forward to working with this committee to developing a base for the corporate minimum tax that is reasonable and fair, yet assures that all profitable organizations pay their share of taxes.

To the extent that if it were shown that DISC, contrary to our expectations would be a disincentive rather than an incentive, we would be willing to talk about it.

Mr. FRENZEL. I thank you for that comment. Two steps down your table is the deduction for amortization of motor carrier operating rights. I suspect that very few motor carriers are going to be paying a lot of taxes this year and in future years, too.

If that gets included in the minimum tax, do you propose that there is some way to carry over these items?

Secretary REGAN. To the extent that in amortizing them they didn't have to use them, we would allow them to be carried over, yes. If they have losses, if that is what you are talking about, to that extent, sure.

Mr. FRENZEL. I am just a little nervous about the fact that we have put what we thought were either equity items or incentives into the tax code; and I am really not very well qualified to talk about most of the things you have put into preference income until I understand the questions a little more, but I think we all agree that everybody ought to pay some taxes.

I think the concept of the minimum is generally acceptable, but I personally am very nervous about blotting out incentives or taking away equities that we worked on very hard and thought were important when we put them into the Tax Code.

That is why I want to proceed very slowly with this minimum tax and I do want to work with you as we move forward on it so that we don't take incentives out that we need for the recovery or that we don't block some reasonable equity that we tried to confer.

Secretary REGAN. I share your view on that. We are putting out probably within a week a very detailed proposal on this so that those affected have a chance to talk to us about it and we will welcome any comments that people affected might have regarding this.

Mr. FRENZEL. I appreciate your statement. I thank you for your testimony.

Chairman ROSTENKOWSKI. Mr. Rousselot will inquire.

Mr. ROUSSELOT. Thank you, Mr. Chairman. Mr. Secretary, last year when the Congress enacted the tax cuts written by the executive branch and the budget cuts written by OMB, totally evading

the legislative process, you presumed certain results in terms of improved economy.

Indeed, since those actions were taken, you have reiterated these promises of higher economic growth, lower unemployment, a higher savings rate, and lower inflation.

I would just like to review a couple of things with you and ask you what has gone wrong and why. The growth rate of the GNP dropped from plus 8.6 percent in the first quarter of 1981 to minus 5.2 percent in the fourth quarter of 1981.

New investment dropped from $212 billion in the first quarter of 1981 to $207 billion in the fourth quarter of 1981. Total employment dropped from 101 million in May to 99.6 million in January, a loss of 1.4 million jobs.

The unemployment rate rose from 7.2 percent in July to 8.8 percent in December. The number of unemployed rose from 7.8 million in July to 9.3 million in December, an increase of 1.5 million. Bankruptcies increased from 277 per week in January 1981 to 396 per week in 1982, a 43-percent increase.

Mr. Secretary, we hear a lot of promises though it seems the only promise kept is the promise that inflation would go down, but at the cost of higher unemployment, negative economic growth and historically high interest rates. Can you explain to this committee what is going on and why?

Secretary REGAN. Sure. This, I have to say, is not the result of the Reagan program. This is the result of a recession coming from the business cycle that has caused the situation that you have just so eloquently described. From the point of view of the Reagan administration, the programs as you well know, Mr. Rousselot, were actually enacted by this Congress in late July and signed by the President in August.

Mr. ROUSSELOT. But the effective date of the business tax cuts were January 1, 1981. Those were supposed to help increase productivity, increase jobs, and they are not. So they were retroactive to January 1, 1981.

Secretary REGAN. I recognize that, but the business community had no knowledge of exactly what they would be until August, and they were not in a position to take advantage of that. At that particular time, the recession had already started, since it started in July.

Along with that came, toward the end of last summer, a return to high rates of interest which again was caused by monetary situations together with the apprehension of the deficits. So, the net result was that no businessman, or very few businessmen, could actually get their programs underway with this combination of high interest rates and a recession. Now, I think that as interest rates come down, as they should be coming down during this recession, and with the tax cuts remaining in place, then you will see the fruition of what we promised when we were talking about the program.

Mr. ROUSSELOT. Isn't it a fact, Mr. Secretary, that high deficits lead to higher rates and one of the reasons why the interest on the debt is higher is because of the higher interest rates?

Secretary REGAN. No. That is not the case. That is the reason I have that chart that I just went over with Mr. Downey attached to

my testimony. This goes back to 1956. You see no correlation between interest rates and deficits.

Mr. ROUSSELOT. Let me just—late last September you expounded on the dangers of large deficits. For example, you stated to the Budget Committee deficits are not good for growth, they are a drag on the economy, divert private sector funds and resources into purchases of Government debt.

You concluded then that we will not be able to achieve the growth of jobs and income we desire unless the deficit is restrained through reduction of Federal spending.

Yet on February 2, at the National Press Club, you took the position that these deficits will not choke off recovery, and real economic growth, which we have yet to see, will make the deficits less onerous.

Would you please explain these inconsistencies in your statement?

Secretary REGAN. It depends what causes the deficit, Mr. Rousselot. There are four different types of deficits.

There are deficits caused by excessive spending, deficits caused by recession, deficits that are caused by tax cuts, deficits that are caused by some combination of all of these.

I would say that when you find out what the type of deficit you are talking about, then you have to see exactly——

Mr. ROUSSELOT. What type of deficit are we dealing with here?

Secretary REGAN. I think the deficit we are dealing with now is a deficit caused by recession.

Mr. ROUSSELOT. Caused by what? Is it caused by interest rates, by Government spending?

Secretary REGAN. Loss of production, the loss of jobs. Every 1-percent increase in unemployment costs at least $25 billion in increased deficit.

Mr. ROUSSELOT. Where in this budget the President has presented has he dealt with the problem of unemployment?

Secretary REGAN. In the whole program, the overall program that we have. There can be no Band-Aid, no quick fix here, that has been tried in the past. As you know, those quick fixes have not succeeded, become effective until too late. The whole program here has built-in stabilizers to it and that is what is going to bring us out of the recession we are in.

Mr. ROUSSELOT. Thank you.

Chairman ROSTENKOWSKI. Mr. Pease will inquire.

Mr. PEASE. Mr. Secretary, I appreciate your being here.

As I indicated this morning with your colleague, Mr. Stockman, I think the key consideration here is credibility of the administration. As late as 6 months ago the administration was predicting a budget deficit for 1982 of $42 billion and insisting that that was going to be the case and predicting in 1984, fiscal year 1984, there would be a balanced budget. Now you are off by tens of billions of dollars from those figures.

I think if anything has been proven in the last year it is that CBO is a lot more credible in terms of its forecasting than OMB.

I think that is tragic, but it is true in my opinion.

Looking at current figures from the administration versus CBO's figures is very instructive. You managed to predict a budget deficit

of $99 billion in fiscal year 1982 and deficits declining to $35 billion by 1987.

CBO uses the same base line projections, but without the cuts that the administration proposes or the additional taxes. Another difference is that CBO assumes a defense spending increase of only 3.5 percent, much lower than that of the administration; but if I use the CBO figures and assume that all the cuts in revenue increases that the administration has proposed are enacted—so that that is the same—CBO comes up with a steadily increasing series of deficits over the next 5 years; and where OMB predicts a deficit of $53 billion in 1987, CBO, assuming the same cuts and revenue increases comes up with a deficit of $126 billion if defense is only increased by 3.5 percent.

Inasmuch as CBO has been much more accurate over the last year than OMB has, why should this committee, why should the American public believe the projections that the administration is giving us?

Secretary REGAN. First of all, I don't agree CBO has been that much better than the administration.

Mr. PEASE. You do agree they have been better?

Secretary REGAN. Even laying that aside for the moment, I suggest to you that as the President said in his state of the Union message to you and the rest of these gentlemen that when you get out to 1987, it is very difficult to project. You don't find in industry anyone trying to project 1987.

This is a requirement of law that has been insisted upon. It is mind-boggling to think that we can be anywhere near accurate in trying to describe what is going to happen 5 years from now.

So I would suggest that we not argue as to who is going to be right in 1987. I think the whole key here is 1984 and 1985 and what happens there.

Mr. PEASE. In 1984 and 1985 using the same figures, except for lower defense on the part of CBO, you are predicting deficits in 1984 and 1985 of $83 billion and $72 billion, respectively. CBO is predicting $106 billion and $112 billion. What is that going to do to the confidence of the financial markets which is essential for a recovery from this recession?

Secretary REGAN. The financial markets are used to having different projections. After all, the blue chip consensus is 44 of the leading econometricians and half of them are above it and half are below, what they come out with on the blue chip consensus.

I would suggest the marketplace is used to having different figures. In fact, most of them use their own or use someone else's rather than either CBO's or ours.

The whole thing here is the trend, I think. That is the most important thing. Is it believable we will be trying to get that deficit down? In point of fact from 1983, 1984, 1985, the deficits will be coming down. I believe they definitely will be coming down rather than going up during that period of time.

Mr. PEASE. Mr. Secretary, this committee, this Congress, and the American people believed you last year when you said that. That is why we are in the pickle we are in right now.

Secretary REGAN. I don't think that is why we are in the pickle right now. I think we were already in the pickle from things that had been put in place long before that, that caused the recession.

Mr. PEASE. Why then was it that last summer you predicted the deficit would go down from $43 billion to $20-some-odd billion to zero over 1982, 1983, and 1984?

Secretary REGAN. Because we had not figured in the terrible recession we are currently into, nor did anyone else.

Mr. PEASE. Very well.

Secretary REGAN. Including CBO. That is what I am trying to suggest. I suggest that in my remarks to the other gentleman that much of this current deficit comes about because we are starting now from a lower base as a result of the recession. We will not be getting as many receipts as we thought we would and the like.

Mr. PEASE. Thank you, Mr. Secretary.

Chairman ROSTENKOWSKI. Mr. Matsui will inquire.

Mr. MATSUI. Thank you, Mr. Chairman.

Mr. Secretary, I would like to follow up Mr. Rousselot's question. You indicate that by the spring of this year, we should have economic recovery, that is a positive growth of GNP. Is that still your statement?

Secretary REGAN. I said in answer to Mr. Downey's question that the recovery—he asked what would be the first quarter that would be a plus quarter as far as real growth is concerned. I said that would be the second quarter of 1982.

Mr. MATSUI. What do you think the long-term interest rates and the prime rates will be around May 1 of this year?

Secretary REGAN. Mr. Matsui, I am not trying to be a wise guy. I spent 35 years ducking that question.

Mr. MATSUI. The only reason I am asking the question is in response to those persons who are saying any recovery will be aborted by the high interest rates.

Secretary REGAN. I think you will find interest rates will be lower than they are now.

Mr. MATSUI. That is what you are predicting? Lower than 17 percent; 13 percent?

Secretary REGAN. Lower than 17 percent on the prime and they will be lower than 14 percent on T bill rates.

Mr. MATSUI. I would like to ask you one more series of questions.

You indicated that the budget deficit has been the result of the recession which I think is obvious to everybody given high unemployment rate and loss of revenues to the Federal Treasury.

You also talked about the fact you were so successful on the inflation rate. This has also caused a loss of revenues to the Federal Treasury. Mr. Stockman said the same thing this morning. I also heard you say that on "Meet the Press" or "Face the Nation" some time ago; and, of course, you said it again in your statement here.

I am a little puzzled by that. I think Mr. Stark alluded to that same thing. You are using the CPI, is that correct, when you talk about inflation?

Secretary REGAN. Either that or the deflator.

Mr. MATSUI. Let's take a look at the figures. In July 1981, when we had the mid-term adjustments that the administration proposed and prepared for us, you still had a deficit figure for this fiscal

year of $42 billion, for 1983, $22 billion, and a balanced budget by 1984.

Your projections at that time, in July 1981, were that the CPI for 1981 would be 9.9 percent, while the actual figure was 10.3.

So actually more revenues should have come in for that period of time.

Secretary REGAN. I don't have those figures in front of me.

Mr. MATSUI. These are accurate figures. I can assure you of that.

Secretary REGAN. We are talking about year-over-year and not quarter-over-quarter.

Mr. MATSUI. We are talking about year-over-year. You should have more revenues in 1981 during that period because the inflation rate was a little higher by four-tenths of 1 percent.

In 1982—in July 1981, you predicted for the 1982 calendar year you would have a 7-percent rate of inflation with the CPI as your index.

Of course, you had the same figures in terms of deficit, $22 billion.

Now, you are predicting under this current budget that the inflation rate would be 7.3 percent. That is based on the CPI. So you are predicting it will be 0.3 percent greater than it was when you predicted a $22 billion deficit. So actually we should have more revenues now under your current projections than we did when you made that estimate in July 1981.

By the same token, it would apply to July 1983. In July 1981, you predicted the 1983 calendar year, the CPI would be 5.7 percent. Now you are predicting it will be 6 percent, which is 0.3 percent higher than you predicted 7 months ago.

Why are you saying that you had a loss of revenues when the inflation rate you are projecting now was greater than in July 1981? Are you making a misstatement to us and the American public to try to make an excuse for the unemployment rate?

Or, in fact, do you have information you haven't disclosed to us?

Secretary REGAN. First of all, I was just told by my staff that our revenues are tied not to the CPI, but the GNP deflator. Our GNP deflator estimates were much above what actually came in, in the way of inflation.

As far as the rest of that is concerned, what I am looking for here—trying to find, and I am unable to find it—is a chart that shows actually how we came out with—from the point of view of spending and the like—to figures that estimate the deficits. I think what has happened here is that revenues have stayed fairly good. They have dipped somewhat from our projections, but I think you will find that spending has increased much more rapidly.

Mr. MATSUI. Mr. Secretary—I yield to the gentleman.

Mr. PEASE. That contradicts the statement, the prepared statement you made where you blamed the problem on insufficient revenue. I have some figures on the GNP deflator, if that is what you are using. You were predicting in March 1982, 8.3 percent; in midterm report, in July 1982, 8.3 percent; and now, 7.9 percent. That is not much of a drop. That hardly seems significant enough to result in the kinds of problems we are in now.

Secretary REGAN. Let's see if I have any figures on our revenues along with those projections.

I am sorry. I will have to give you that for the record, Mr. Matsui, Mr. Pease, as to exactly how that came about. I am unable to put my hands on it right at this moment.

Mr. MATSUI. I continue to yield.

Mr. PEASE. I wish you would do that. Your statement to us a minute ago was, "However, the revenue picture has been heavily affected by two factors, the recession, which is obvious, and the drop in inflation." It doesn't seem to be to us the latter is the case.

Mr. MATSUI. Mr. Secretary, I hope you will check out this matter. The information we have is that the deflator will be even greater than you predicted in July 1981. That being the case, I hope you won't say on national TV. any more that because you were so successful on the inflation rate, that revenues have gone down therefore.

That is not a true statement.

Secretary REGAN. I will not promise you that until I check the figures.

Mr. MATSUI. When you check the figures, I am sure you will find yourselves corrected.

Secretary REGAN. You cannot require me to say something that may not be the case.

Mr. MATSUI. I am just saying check the figures. You will find that to be the case. I hope you will correct that, because it is a misstatement.

Secretary REGAN. If it is a misstatement, I will correct it. I don't think it is a misstatement.

Chairman ROSTENKOWSKI. Mr. Heftel will inquire.

Mr. HEFTEL. Mr. Secretary, I do want to agree with something that you said. The financial marketplace, as we both know it, isn't going to look at your projections or the CBO projections; it is going to make its own projections. I am sure that if a number of individuals like myself were able to make our own projections a year ago and tell our constituents as we did there was no way we will have a $40 billion deficit—on the low side, it will be $80 billion, and on the high side, it will be $100 billion—then the financial market can and does make such independent projections, as well.

I don't like to tell you this, but I have to. That was the way I communicated with the people who I have a direct responsibility to.

I think there is a more basic problem, one that you are very familiar with. There are those in the business world who would come in with their budgets and their projections based on the low side of interest rates, a high side of revenues, and the high side of efficiency and of productivity.

Then there are those who will come in always on the low side of revenues, the high side on interest rates, and the low side on productivity. They don't want to get caught with their pants down, no money in the till, and having to go to a board or stockholders groups and explain what is wrong.

They want to know if they can be relied upon. That is hard to do in the public sector. As you well know, you are constantly being pushed to come up with the most optimistic view you can to keep the system moving and working.

I am afraid we have reached the point where everybody now knows that the projections aren't worth much, that they are based upon these optimistic views which are very dangerous; and as a result, the financial community is just waiting to see; and they are taking advantage of whatever they can get along the way.

We tried to say that your so-called Economic Recovery Act was just simply not going to work. The first would basically eliminate the corporate income tax; second, it would skew the system; and third, you would have manipulation going on between companies in a way that was nonproductive. That is where we are at now. You are now proposing tax increases for corporations that try to get back half or more of what you already gave away, but no one seems willing to say we made mistakes.

We have got to sit down and redo from ground zero where we started and figure out what it is we are trying to achieve and then what to put in place to achieve it with.

Until we do that, we are going to have these embarrassing moments where you keep coming back here trying to explain why your projections were not correct and we try to embarrass you because we now know that they are always too optimistic and you are not in any way going to be able to achieve them.

When do we take the political risk, in effect, of telling the truth? Until we do that, we are going to live through what we saw, frankly, with Jimmy Carter, what we are now seeing with Ronald Reagan, and whatever we will see in the future.

Secretary REGAN. Mr. Heftel, I have to say on that it depends on—it is like the old story of looking at the bottle—is it half full or half empty? There are many ways of looking at the economic forecasting. We have chosen what we think is a logical path based upon the economic situation that we find ourselves in, the current position of our tax cuts, and what we think can be accomplished with the Congress in the way of further budget cuts.

I think you will have to agree with me that what the financial community also wants is less Government spending. They want to see that the Government spending is getting under control.

Mr. HEFTEL. Mr. Secretary, I could not agree more. If we don't cut Government spending, we are not going to bring the economy under control. That is not the issue I am trying to discuss with you. It is rather the issue of whether or not the net result is going to be escalating deficits which are going to be self-defeating and which is where we are at until we come in and say, here is the income and here is the expense, this is the best we can project, and here is what we have to do. If we don't, we are going to face the consequences. I don't believe that that has been done.

I don't know if politically you can do it.

Secretary REGAN. What I am suggesting is we have to look at both sides, both the outlays as well as the receipts in our projections and trying to project outlays, you have to have some type of economic forecast.

To the extent that that economic forecast is low-balling, you may come a cropper on your outlays also. You may find you have been too low on them rather than on the other side, and similarly high-balling with receipts. It is not easy to do.

Mr. HEFTEL. I just know that you know what should be done. I know you have the knowledge and ability to do it. I know the system isn't making it possible for you to do it. Somebody is going to have to do something about that state of affairs or we are going to have competent people like you and Mr. Stockman in here embarrassed when they shouldn't be embarrassed because they should have been able to come in in the first place and tell it like it is.

Chairman ROSTENKOWSKI. Mr. Bailey will inquire.

Mr. BAILEY. Thank you, Mr. Chairman.

Mr. Secretary, I don't want to introduce another problem with the equation between receipts and inflation rates——

Chairman ROSTENKOWSKI. Would you speak into the microphone, Mr. Bailey, so we can hear you?

Mr. BAILEY. I am grateful that the chairman wants to hear my words of wisdom.

It seems to me there has to be some relationship also between deficit and spending and a reduced inflation rate because of the reduced costs of goods and services to the Government. I don't know if that relationship is direct or when it takes effect. I would assume that it does. I don't know about some of those arguments. We have this big deficit problem just because our receipts are lower, because inflation has dropped. There has to be some modification there.

I want to ask you about leasing. Senator Dole, February 19, indicated that he had some desire to introduce legislation or for some reason or other he wanted to see some retroactive effect taken that would limit so-called safe harbor leasing. He has apparently been successful because the market has—at least the word I get—has dried up.

You are not in favor of that, Mr. Secretary, are you?

Secretary REGAN. No, I think if you will recall a little bit of the history of how we got into leasing——

Mr. BAILEY. I only have so much time. Please. You are not in favor of what Mr. Dole?

Secretary REGAN. I just want to say I, of course—newspaper reports are all I have seen of what Senator Dole said. To the extent he said that anyone else entering into leasing from now on—no, I think that is throwing the whole business world into confusion.

Mr. BAILEY. I am glad to hear you say that, Mr. Secretary.

I am sure Mr. Dole will take cognizance of your words and it is good to hear the administration will not be supporting that point of view.

Your alternative minimum corporate tax and the inclusion of leasing provisions as a preference item—you mentioned it in language of excess of net cash investment.

I assume net cash investment is a definition extended beyond section 38 property; you are into ITC property, talking about their net investment for ITCs, deductions, the whole bit, whatever is eligible for leasing, is that right?

Secretary REGAN. Hold it until I check with my experts.

You have to remember that the net cash investment is the actual amount that is in actual cash put up, not the total cost of the machinery or the building or what-have-you.

Mr. BAILEY. That is what I was afraid you were going to say. You didn't want to go with the targeting mechanism and you want to

avoid the appearance of refundability, although I don't think you could, at least not with this mechanism.

Incidentally, I have no difficulty with that. I think we have national policies we sure as heck better get straightened out in the capital intensive area.

We are going to have severe national defense problems in the future. Mineral development, and so forth.

In line with Mr. Frenzel's questions, and Mr. Gradison's fears, I would like to add mine, because you are talking about a mechanism which might increase just because you fear some negative effective tax rate.

I am sure that is your fear. You are talking about a mechanism that may increase their liability under current law 5 or 6, maybe 10 times. You are going to be putting a foot on those people who very legitimately take advantage of a tax code that we have devised, deductions that we have devised, accelerated depreciation that we have devised, investment tax credits which we have structured and give them a tax rate that actually is higher than zero and unnecessarily.

I think that is a real possibility. I hope you will take a look at it. I invite your comments on that.

Please be receptive, Mr. Secretary, to the impact on capital intensive investment of some of these recommended changes.

Secretary REGAN. I agree. What I think you have to remember is that I think 75 out of 100 Americans would say notwithstanding all of the preferences that we have given to business and all of the tax breaks we have given to individuals, that every individual and every corporation should pay at least some tax.

This is a minimum tax.

Mr. BAILEY. Let me tell you what. I represent——

Secretary REGAN. It is an alternative minimum tax only.

Mr. BAILEY. I represent a lot of Democrats. I have a very good union voting record. I believe in unionism, 100 percent. I have no difficulty whatsoever with understanding the problems with this Nation's economy.

The best things that you people talked about were reinvestment and the need for it. I wish you had talked about it in a broader context, in terms of other nations' tax policies, trade policies, interest rates and all those kinds of things.

I don't have a damned bit of difficulty saying to you right here and now if a corporation doesn't pay any tax and they have got an investment problem and they want to put in a continuous caster or they are a railroad that needs help, I don't have any problem with them at all not paying tax. I want you to know that. That is from the other side.

Secretary REGAN. I hope the same company doesn't go out and buy an oil company.

Mr. BAILEY. Frankly, you mentioned the foreign tax credit.

"A foreign tax credit, which essentially is where most of our big oil companies would apply that credit against American corporate tax liability, is the only existing——

Secretary REGAN. No, they have to apply that against whatever investment they make in the United States.

Mr. BAILEY. I am very much aware of that distinction.

Let me read the paragraph. Then I will tell you what you throw in here as an alternative hasn't any impact on that. Correct me if I am wrong. I may be mistaken. Correct me if I am wrong.

Chairman ROSTENKOWSKI. Conclude pretty fast, Mr. Bailey.

Mr. BAILEY. Thank you, Mr. Chairman. You are very kind.

"Foreign tax credit is the only existing credit claimable against the alternative minimum tax. Investment tax credits which give no benefit due to the minimum tax should be carried forward."

What impact is that going to have on a large profitable oil company that can look forward to coming years of sufficient profits against which to write off these ITC's?

Secretary REGAN. May I answer that for the record later? I will submit my answer in writing.

[A response to the question was not received.]

Chairman ROSTENKOWSKI. I want you to know, Mr. Secretary, Mr. Bailey closes much more vociferously than when he begins his interrogation.

Mr. BAILEY. Along with the help the administration has given us today, I would like to thank the chairman for his vote of confidence and support.

Chairman ROSTENKOWSKI. Mr. Guarini will inquire.

Mr. GUARINI. Thank you, Mr. Chairman.

Mr. Regan, I want to thank you for ably putting forth the position of the administration. It is too bad our process doesn't open itself up so that all the representatives of the administration can say where they disagree and what they really feel inside.

I don't feel that you could be that far apart from the financial community on Wall Street which you have been so much a part of for so long. I am sure you can't be marching in completely the other direction.

Unfortunately, our predictions haven't been so good. Unfortunately, from what I understand from Mr. Stockman this morning, there is no real alternative or backup plan.

If this doesn't work, we have to start a national dialog, look at our options, and with a big country like ours, it would take a great deal of time to go in another direction and pass corrective legislation.

What concerns me very much is the fact that we admittedly, in fiscal year 1983, have a $92 billion deficit with the baseline assumptions. If two of those assumptions are just one point off, the GNP assumption will be $17 billion off; if the unemployment rate was one point off, there would be $28 billion in lost revenues.

What also bothers me is that added to that $45 billion could very well be $56 billion if the President's program doesn't go through. I have heard statements from witnesses that they are against or have reservations about the minimum corporate tax, the modified insurance tax proposal withholding of interest and dividends, and so forth.

So there is no assurance that we are going to have the savings implemented.

So, therefore, if $147 billion is our exposure for fiscal year 1983, with very low assumptions, we can possibly hit far in excess of a $150 billion deficit in 1 year.

When I think of the fact that we had less than $100 billion as an accumulated national debt at the time of Lyndon Johnson, this really boggles the mind.

I am wondering about our national priorities. I am wondering whether the bidding we did between the Democratic and Republican Party really hurt our Nation.

I am very, very concerned not because of the numbers I hear mentioned all day long. This has been the day we talk big numbers all day long. What we are really talking about is people. We are talking about human suffering. We are talking about unemployment. We are talking about the hardening of the attitudes toward people, talking perhaps about insensitivity toward people. Maybe if Reaganomics doesn't work, it will become Reaganitis.

We will have a severe inflammation of our economy. These are things that I think concern all of us. It is the farmer in Iowa, the miner in West Virginia, and the industrial worker in Massachusetts who is making $12,000, $15,000, $18,000 a year who is really involved in all these numbers we are talking about. It's the worker with several children, not having school lunches, not having job training programs for his children and not having various kinds of entitlements which he has counted on, and there is going to be a tremendous amount of human displacement.

I am very, very, concerned because all of this cutting we are doing is because we are trying to preserve the military budget. This is a good part of it. Nobody wants to attack the sacred cow which is our military budget.

I heard on the radio this morning that we may be in for $10 to $25 billion of subsidization from Japan because our industries need an infusion of capital.

The Trade Representative of the United States has indicated that he is seeking some kind of help from Japan because of our imbalance of trade. It is unfortunate that we who have won the war, 30 or 40 years later, are becoming a welfare state looking to Japan for charity when we should be able to pull our own act together.

Why can't we require other countries to do their share of the military effort, which we seem to be carrying on for the whole world? Why can't we get a better share of world trade? Why can't we cut back on our military spending when we know that it is not productive? We know it is inflationary. We know it is low labor intensive, not geared for employment because we are dealing with capital intensive weapons systems.

So what I want to know basically is, why do we let the industrial military complex virtually rule us when one of the things that Eisenhower, a five-star general—tolds us "Beware of the military/industrial complex."

This was the one message he gave our Nation. This is the one sacred cow we seem to refuse to touch.

What bothers me is that when the Army generals and when the Navy admirals and when the procurement chiefs leave Government service, too often they are hired by big companies that are supplying military hardware.

What bothers me is that we don't want to go after them; we don't want to touch them because it seems that they are the ones that have a sacred preserve in our economy. What kind of a pro-

gram do we have to protect the public against the industrial/military complex, sir?

Secretary REGAN. Is that the question you are asking?

Mr. GUARINI. Yes, sir. I had to build up to it.

Secretary REGAN. How much time do I have, Mr. Chairman?

Mr. GUARINI. I think it is a very important question, Mr. Chairman.

We have special interests in Washington that really have an inside track on our economy. I think that deserves an answer.

Chairman ROSTENKOWSKI. Let the witness answer the question.

Secretary REGAN. First of all, I would have to deny many of the things you had to say regarding our program and what we are trying to accomplish.

I think you have misconstrued it and bent it out of shape so I hardly recognize it.

I would say this: What we are trying to do is make a strong America. We feel that at the current posture, the United States is not No. 1 in the world by any stretch of the imagination.

We are an inferior nation at least to one other nation in our military posture. What we are trying to do is put America back to where it should be, at least equal, if not superior, to anyone else in the world. That is what we are trying to do.

At the same time, what are we trying to do for those individuals that you were talking about in your opening remarks?

I would say that what we are trying to do there is to bring prosperity back to this country. That is the whole essence of what we are trying to do. We are trying to give people incentives. We are trying to give incentives to save, work, to invest.

That is the reason for the tax cuts. That is the reason we are trying to cut the size of the Federal Government. We have to do that sort of thing. That is exactly what America has been asking us to do, to get the Government off their back. That is what we are trying to do for them.

Chairman ROSTENKOWSKI. The time of the gentleman has expired.

Mr. Anthony will inquire.

Mr. ANTHONY. Thank you, Mr. Chairman.

Mr. Secretary, I would just like to make a comment as a follow-up to what Mr. Guarini said just to let you know how a 15-year-old student in my household feels about that Japanese bailout.

She is studying Government this year and has asked an awful lot of questions and asked me to bring a lot of material home to her. She said she thought it was embarrassing. I must admit I find it somewhat embarrassing also.

Let me say this: If they are going to provide $10 billion of 6-percent money for needed worthwhile projects, I have a few in my district I am going to make application to them because we can't get the money from any other place at that rate. I am going to be in there looking.

Do you happen to know Dr. Charls E. Walker?

Secretary REGAN. Yes, I do.

May I answer on your first question?

I would caution you to tell that teenager in your household to be very careful of that. Let's take a very close look at that gift horse.

That was not proposed by the Japanese Government. The Japanese Minister of Finance, the Japanese Minister of Trade, the Japanese Prime Minister, have all said publicly they don't know what that is about. That is the proposal of a Japanese American, a citizen of the United States who thinks that is the way to solve things.

That has not been offered to us by the Japanese Government. It is no bailout by Japan of the United States. I would caution you not to get too upset about that one.

Mr. GUARINI. Will the gentleman yield?

On national television this morning Trade Representative Brock appeared with the chairman of the Japanese Trade Institute and was very much in favor of and approved of this loan that would go, being subsidized by Japanese businesses, not the Japanese Government. However, they would set up a government apparatus for it and the U.S. businesses.

Secretary REGAN. I have been around a long time. I would wait until I actually see the whites of that loan.

Mr. ANTHONY. Back to really what I wanted to quiz you about. Do you know Dr. Charls E. Walker?

Secretary REGAN. Yes, I do.

Mr. ANTHONY. You don't consider him a crackpot, do you?

Secretary REGAN. Only on certain things.

Mr. ANTHONY. I am afraid to ask you in what categories you consider him to be a crackpot. I know he is a very strong supporter of the President. He is a very strong supporter of the 1981 tax cut. He is also very supportive of not having a change in direction.

In other words, he would not like to have a fundamental change, either, of the President's program; yet, he participated with four other business representatives on a panel last week before this committee. I must admit that he said some things that really startled me, and I think maybe startled some people on this committee.

I would like to read a portion of his testimony and then go to one of the proposals that he made and then ask for your comment about that proposal.

On page 5 of his testimony, he says:

> My view is that Federal deficits which do not exceed 4 percent of GNP can probably be financed without excessive monetary expansion but deficits in the next few years threaten to rise significantly above that percentage. Moreover, if markets quite clearly believe that the deficits now in prospect spell trouble, thus impeding the decline in interest rates justified by the improved outlook for inflation. In addition, deficit financing as a way of life is bad public policy. It removes a practical limit on growth of the Federal sector and, remember, it is that growth that got us into this mess in the first place.
>
> Chronic deficits also rob financial markets of funds that could otherwise be used to support the capital formation this country so badly needs. An adjustment to the economic game plan that will sharply cut near term deficits and return us to a balanced budget relatively soon is therefore urgently needed. This correction need not at all disturb the basic framework of Reaganomics that the administration and the Congress put in place last year. It is an adjustment that should be negotiated between the Congress and the administration in a spirit of compromise on a bipartisan basis.

Then he did mention three things, two of which you did not mention in your tax incentive package. One, an oil import fee of $5 a barrel, immediate decontrol of natural gas with an excise tax tacked to it; but thirdly, more importantly, in his personal viewpoint, he says that he would, if you need additional revenues to

narrow the deficits, consideration of a delay, not a suspension or elimination, but of a delay of all or part of the 10-percent individual income tax cut scheduled for July 1 of 1983.

Then he proceeds to tell you how many dollars we could pick up: $9 billion in 1983; $27 billion in 1984. If it were postponed or extended until January of 1985, the deficit would be reduced by $37 billion.

I would just ask you this. Do you personally feel if it were postponed—not eliminated—that that would be changing a fundamental thrust of the President's program?

Secretary REGAN. Yes. I think postponing it would be the wrong thing to do, it would be sending the wrong signal at the wrong time. I have an additional chart here which I will put into the record to show you. What these lines actually indicate is what happens to a $20,000 a year family under Mr. Walker's proposal and under current law. You will see this line going up here. Those are the additional taxes that that person would be paying while the postponement is in line. This is what is the current tax law of the United States.

Now that starts to widen quite a bit.

What you are asking a person with a $20,000 wage income in 1982—a family of four—to do is pay an extra, approximately $300 a year in taxes out of $20,000. Why? Because—just because he thinks deficits of that nature cannot be reduced in any other fashion.

I say that the proper way to do that is to do it through budget cuts. In other words, cutting back on the Government, not putting more taxes onto the individual worker who is having a struggle right now to make ends meet.

Mr. ANTHONY. Let me close with one comment. I agree with you on a cut in spending. I will support you in trying to cut spending as a percentage of the GNP. I have been home to my district. I have listened to my people. Rich people, middle income people and poor people have told me since I have been home over the last 4 weeks: if you have to take my tax cut back if it will help balance the budget, bring interest rates down, and get investment and productivity going again, go right ahead. And please also do a little bit, something about trimming the defense budget.

So as their elected representative, I am charged with doing those two things until I hear different from them.

Mr. PICKLE. Mr. Secretary, I have a question, but I will yield to the chairman.

Chairman ROSTENKOWSKI. You may proceed.

Mr. PICKLE. Mr. Secretary, I didn't get to pursue fully the questions I raised with respect to your proposed deficit reductions. By way of review, your budget shows tax increases of $12.7 billion, budget cuts of $25.9 billion, and management efficiencies, $17.3 billion; total $55.9 billion. Some of these things I think the Congress ought to consider seriously and perhaps we can adopt some of these. We are not going to take them all because they are so very controversial. Some of them it seems to me are in the realm of wishful thinking. Help me on this one point.

Here you have under the increased IRS staff a savings of $2.1 billion. You are going to hire 500 new employees.

Secretary REGAN. No, 5,000.

Mr. PICKLE. Oh, 5,000 new employees. Last September you reduced the IRS staff by 4,100 people. It seems to me like you are blowing hot and cold if you come in and say you are going to hire 5,000 when last year in order to save money you cut off 4,100. I think those figures are correct. If that is not so, it can be corrected.

How do you justify by adding 5,000 you can save that much more money? Do you think times have changed?

Secretary REGAN. The positions we eliminated in IRS were not those of agents who actually look at returns, go after delinquent taxes. The positions that we eliminated were positions primarily in the information field; very frankly, we are cutting back on the amount of free information we are giving to taxpayers and the like. As far as the agents themselves are concerned, the IRS for years has run studies on the average amount of collections an agent can make. That is exactly where we came up with the $2.1 billion.

Mr. PICKLE. What you are saying, is that the people you want to hire now are agents?

Secretary REGAN. Agents.

Mr. PICKLE. Have you ever given to us a report showing where you made those cuts last September, in what categories?

Secretary REGAN. We gave that to the Appropriations Committee, I believe. I will be glad to furnish it to this committee.

[See p. 323 for response to question.]

Mr. PICKLE. I wish you would. It would be interesting to see it. On the one hand, 90 days ago, you were cutting off 4,100 people. Those may only be staff, but you can't have all agents and no staff. It seems to me like you are reversing your field. It disturbs me.

Also, in that connection, explain this: you are going to save $2.1 billion by increased staff under the tax collection section. Then down under the improved debt collection, you are going to save another $1 billion. Is that the same thing?

Secretary REGAN. No.

Mr. PICKLE. That is in addition?

Secretary REGAN. Those are other debts owed to us besides taxes: student loans, small business, things of that nature. There are literally billions of dollars owed to the United States in amounts of loans apart from taxes.

Mr. PICKLE. There is a difference. I can see that. The $1 billion you are going to save in the direct collection has nothing to do with the Internal Revenue agents?

Secretary REGAN. That is right.

Mr. PICKLE. I notice you are going to save a billion dollars in Federal property disposition. I see that figure. I just have a feeling that was pulled out of the air, that you are going to save $1 billion. Can you tell me how you are going to save $1 billion? We haven't seen these proposals. We have to kind of guess at how you would do it.

Secretary REGAN. I think what you will see coming up from various types of people, both the Interior Department and other departments of the executive branch have been asked to see what surplus property we have. I will give you an example. From Treasury, the New York Assay Office. We are closing the New York Assay Office in Lower Manhattan. We are shifting all of their activities up to West Point, N.Y., where we can conduct exactly the

same type of business. We will have that property available for disposal; and accordingly, that is part—I don't know how many millions that piece of property might be worth.

It is that type of thing that goes into that surplus property.

Mr. PICKLE. Isn't that the type of thing you normally carry on year in and year out and don't put on a special campaign just for revenue purposes? Or is it just something you raked in to try to make the figures look better?

Secretary REGAN. No, we didn't rake it in to make the figures look better. This is something the President talked about in the campaign about spotting lands and buildings that are available that are excess Government properties. You probably have heard many stories about the Government holding on and hoarding land and the like. It is this type of thing that we think it is time the Government gave up.

Mr. PICKLE. One other question. I notice under guaranteed student loans you are going to save $800 million and under elementary and secondary education, over $1 billion. That is almost $2 billion you are going to save in education. Last year in the social security bill we phased out survivors' benefits and we did it with the assurance of the administration that we do that now because there is a student loan program and that would be the proper source for it; and the approach we adopted was not what we, this committee, recommended. It was put into reconciliation. We couldn't get to it. It is now the law.

We cut out some $2 billion plus in savings in that area; but now you come and you cut the student loan program and the guaranteed loan program by some $2 billion.

It seems to me like you are committing a double whammy against students when you, on the one hand, do away with all the survivors' benefits and on the other hand weaken, cut the student loan program in half.

Secretary REGAN. No, that student who would be the survivor who had been receiving survivor benefits to go to college would probably be eligible for a Pell grant, if the family has annual income of about $15,000 or he might even be eligible if the family has about $20,000.

Mr. PICKLE. Mr. Secretary, I think you are making sizable cuts in the Pell grants.

Secretary REGAN. What I am saying is that student would still be eligible for it. All we have done in the Pell grants is cut back the income of the family to where—it is now $15,000 and less that are eligible for Pell grants; $25,000 and less would be eligible for other student loans.

Mr. PICKLE. Does the $1 billion savings in debt collection include social security overpayments? Do you know?

Secretary REGAN. No, I don't believe it does. I don't think we have done anything in the social security area until such time as we hear from that Commission.

Mr. PICKLE [presiding]. Mr. Secretary, Mr. Holland, who wasn't able to attend, has asked me to ask one question of you, only to have it answered in the record.

Mr. Secretary, as you mentioned in your testimony, the administration wants to prohibit tax reductions realized by some life insur-

ance companies through modified coinsurance arrangements provided for this section 820. It is my understanding section 820 is not the only problem in the law governing the taxation of life insurance companies, that indeed much of the current law is outdated and presents some serious problems for life insurance businesses.

Do you agree?

If you would answer that for the record at some time in the future, Mr. Secretary, I would appreciate that.

[See p. 321 for answer to question.]

Chairman ROSTENKOWSKI. One last thing, Mr. Secretary. We have gotten to know each other pretty well in the last 12 or 15 months. I like all the catch words—wiggle room, flexibility, work together. Those are all very important.

I would just like to ask one question and get your observation on it. Let's suppose that the Congress sent a bill to the President this year which had bipartisan support, which contained some revisions in ACRS, or which contained some revisions in the individual income tax cuts. What would the Secretary of the Treasury recommend to the President of the United States with respect to whether the President should sign such a bill?

Secretary REGAN. Well, I have learned something, Mr. Chairman, in close association with you and these other gentlemen over the past year. I would say I would have to take a look at that very carefully.

Chairman ROSTENKOWSKI. Mr. Secretary, I would expect you to do that. I would expect you to give me that answer. I would also like to make some observations to you about this committee.

I think that the structure of last year's tax bill evidences a certain degree of cooperation. I was proud of this, because you and I negotiated over a period of several weeks, and I thought we would come to some fruitful conclusions.

In my opinion, we need a tax bill. What it will take is a mix of ideas. We Democrats do not speak with one voice. As the administration, you have the opportunity to speak with one voice. I just hope that the one voice with which you speak will be flexible, because if the President is in cement on what he has recommended, I think we have a problem.

I also think that there could be no need for a bill.

Let me point out why I make this observation. You and I are interviewed by the press quite frequently. You are familiar with the tenor of the questions that are asked by the press: Could there be a stalemate? Could there come a point where no one will give? When you hear this from the press, you start thinking about assumptions. It is strange that when the press or the public generally starts assuming things, the Government begins to move in that direction. I hope that is not the case here.

I hope that we can work in an atmosphere of flexibility, maintaining respect for each other but ultimately concluding with some constructive legislation for the benefit of the people of this country.

You may not think that we are in trouble. However, I just returned from my district, Mr. Secretary. There are a lot of people out there looking for jobs. There are a lot of people wondering whether or not we will be able to come through this economic crisis. I interpret my constituency as representative of people

throughout the country. I do not believe that the American people will be patient and will sit back and let us drift.

I recognize an olive branch when I see it, and I want you to understand that I, in turn, offer the olive branch on behalf of this committee. However, I hope that we can enlarge on that flexibility. I hope that there will be a truly cooperative effort in the structure of future legislation. That will be essential.

Secretary REGAN. Mr. Chairman, I thank you for those words and the kind offer. It goes without saying, obviously, in the technical field anything you want on any tax matter, the Treasury Department stands ready to give you that cooperation. As far as tax policy is concerned, if there are no ideas, if there are different ideas, differences of opinion, I am more than willing to talk to those differences in policy; and to the extent that there are brand-new ideas, or even old ideas that are renovated, that look as though they might be part of some comprehensive package that this Congress might be trying to fashion, I am sure the President of the United States would welcome that, to listen to such things.

Chairman ROSTENKOWSKI. Mr. Secretary, I spoke to the same National Press Club audience that you did about a week before you. It is hard for me to conclude that members of a legislative body can speak as forcefully with one voice as the administration can. That is why I wonder whether big men, true leaders—do not rethink programs—do not look at what is necessary and admit if there is a mistake. Leaders are not afraid to rethink their positions, give guidance, and give cooperation.

With that, if there are no further questions—Mr. Duncan will inquire.

Mr. DUNCAN. Speaking without one voice, Mr. Chairman, I would say we usually follow what the Democratic Caucus tells this committee to do.

Chairman ROSTENKOWSKI. I wish you had done that on the floor of the House of Representatives when we passed the tax bill last year. We would be in better shape today.

Secretary REGAN. Mr. Stockman tells me regardless of the bill this committee proposed and the one that finally passed, there would be very little difference in the economy.

Chairman ROSTENKOWSKI. Mr. Stockman is talking about the product that we negotiated, Mr. Secretary. When I concluded discussions with you, the tax bill I was talking about as an alternative was only a 2-year bill.

Mr. Secretary, thank you very much. It has been a very enjoyable afternoon. I hope we can resolve our problems and the country's problems together.

Secretary REGAN. I hope so, too.

[Whereupon, at 4:25 p.m., the committee was adjourned, to reconvene Tuesday, February 23, 1982.]

[Subsequent to the hearings, the following exchange of correspondence took place:]

COMMITTEE ON WAYS AND MEANS,
U.S. HOUSE OF REPRESENTATIVES,
Washington, D.C., February 24, 1982.

Hon. DONALD T. REGAN,
Secretary of the Treasury
Washington, D.C.

DEAR MR. SECRETARY: In regard to your testimony before the Committee on Ways and Means on February 22, 1982, on the President's Economic Program, I am forwarding the attached list of questions for your written response in order to complete the Committee's hearing record.

You will recall that Congressman Frenzel mentioned at the hearing that he would like to submit some questions to you for the record on the taxation of life insurance companies as well. These questions are numbered 1 through 3 on the attached.

In addition, in order that the Committee can fully understand the economic assumptions upon which the Budget is based, please supply us with the net investment rate and the savings rate projected for 1982, quarter by quarter, and 1983, 1984, and 1985. Further, please provide us with the Administration's estimates of the federal borrowing absorption rate for fiscal years 1982-85.

Finally, in regard to the questions directed to you by Congressman Pickle at the close of the hearing, questions 5 and 6 clarify and expand upon the material we would like submitted for the record.

I appreciate your cooperation in this matter and would request that your responses to these questions be provided by March 12, 1982.

Sincerely yours,

DAN ROSTENKOWSKI, *Chairman.*

QUESTIONS SUBMITTED TO SECRETARY REGAN FOR THE HEARING RECORD, FEB. 22, 1982

A. FRENZEL/HOLLAND QUESTIONS

(1) Mr. Secretary, as you mentioned in your testimony, the Administration wants to prohibit tax reductions realized by some life insurance companies through modified coinsurance arrangements provided in Code section 820.

It is my understanding that Section 820 is not the only problem in the law governing the taxation of life insurance companies; that, indeed, much of the current law is outdated and presents some serious problems for the life insurance business. Do you agree?

(2) Following-up on the previous question, I understand that the life insurance business has devoted considerable time in drafting proposed changes in the Life Insurance Company Income Tax Act of 1959. This reform proposal has been discussed with you, other Treasury officials, and with many of us on the Hill.

The current law is very complex, as are the industry's proposed solutions. Many of us feel that an effort should be made to find a simpler, long-range solution.

Would the Treasury Department be prepared to work with the Congress and the life insurance industry to do this?

(3) To continue further, Mr. Secretary, this fashioning of a new approach would take considerable time. However, the life insurance people have two problems of a more immediate nature—the treatment of companies using modified coinsurance arrangements and companies crediting excess interest—two issues which the Treasury Department has identified for special attention.

I understand that the industry has suggested the development of a two-year "stopgap" proposal which would leave the current tax law basically intact, except for addressing these two problems. Inasmuch as the stopgap would be temporary, pressure would still be maintained to arrive at a more permanent solution.

Would the Treasury Department be inclined to consider the adoption of such a stopgap—one which would address the ModCo and excess interest problems while, at the same time, generating a significant increase in revenues?

B. ROSTENKOWSKI QUESTIONS

(4)(a) Please supply the Committee with the Administration's projections, as assumed in the President's Budget for Fiscal Year 1983, for the net investment rate and the savings rate for 1982, quarter by quarter, and 1983, 1984, 1985.

(b) Please supply the Committee with the Administration's estimates of the Federal borrowing absorption rate for Fiscal Years 1982 through 1985.

(5) In regard to staffing plans for the Internal Revenue Service, please provide the Committee with the following information:

(a) Details on the staff and dollar reductions, by function and activity, which took place as a result of the 4,100 personnel reduction in 1981.

(b) A detailed description of the changes that have occurred or are planned in Fiscal Years 1982 and 1983 in the Taxpayer Service function as a result of these reductions and the effects thereof expected on taxpayers.

(c) Details on the allocation of the 5,000 increase in staffing proposed for I.R.S. in Fiscal Year 1983, and related dollar amounts, by function and activity.

(6) The Fiscal Year 1983 Budget estimates $1 billion in additional revenues from debt collection activities. In October, 1981, at the hearing held by the Committee on Ways and Means on H.R. 4613 in regard to debt collection, OMB estimated a gain of $500 million annually from the composite of the Administration's debt collection initiatives (No. 97-26, pg. 63).

Please explain this discrepancy and supply us with the details used to arrive at this new estimate in comparison with the information supplied the Committee in October, 1981.

THE SECRETARY OF THE TREASURY,
Washington, D.C., March 16, 1982.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: I am enclosing my response to the questions forwarded by you in your letter of February 24. I agreed to provide answers to these questions in my testimony before your Committee on February 22.

Please contact me if any further information is required.

With best wishes.

Sincerely,

DONALD T. REGAN.

Enclosures.

ANSWER TO QUESTIONS SUBMITTED TO SECRETARY REGAN FOR THE HEARING RECORD

A. FRENZEL/HOLLAND QUESTIONS

Question 1. Mr. Secretary (as you mentioned in you testimony), the Administration wants to prohibit tax reductions realized by some life insurance companies through modified coinsurance arrangements provided in Section 820.

It is my understanding that Section 820 is not the only problem in the law governing the taxation of life insurance companies; that, indeed much of the current law is outdated and presents some serious problems for the life insurance business. Do you agree?

Answer. The Treasury Department recognizes that section 820 is not the only problem in the law governing the taxation of life insurance companies. There are numerous Internal Revenue Code provisions applicable to the life insurance industry that do not work properly. Some of these provisions work to the detriment of the insurance industry; others work to the industry's advantage. It is not clear whether the flawed operation of current law causes life insurance products to be overtaxed. The Treasury Department does not believe that, following the repeal of section 820, current law would overtax life insurance.

Question 2. Following-up on my previous question, I understand that the life insurance business has devoted considerable time in drafting proposed changes in the 1959 Act. This reform proposal has been discussed with you, other Treasury officials, and with many of us on the Hill.

The current law is very complex, as are the industry's proposed solutions. Many of us feel that an effort should be made to find a simpler, long-range solution.

Would the Treasury Department be prepared to work with the Congress and the life insurance business to do this?

Answer. The Treasury Department is willing to work with Congress and the insurance industry in examining the tax treatment of life insurance companies. We recognize that the current law is quite complex, and that a simpler statute may prove more workable in the long run.

Question 3. To continue further, Mr. Secretary. This fashioning of a new approach would take considerable time. However, the life insurance people have two problems of a more immediate nature—the treatment of companies using modified coinsur-

ance arrangements and companies crediting excess interest—two issues which the Treasury has identified for special attention.

I understand that the business has suggested the development of a two-year "stopgap" proposal which would leave the current tax law basically intact, except for addressing these two problems. Inasmuch as the stopgap would be temporary, pressure would still be maintained to arrive at a more permanent solution.

Would the Treasury Department be inclined to consider the adoption of such a stopgap—one which would address the ModCo and excess interest problems while, at the same time, generating a significant increase in revenues?

Answer. We understand that there has been an intense effort on the part of the life insurance industry to produce a two-year "stopgap" proposal. To date, the industry has not developed a proposal that is satisfactory to all segments of the industry. For this reason, we cannot say whether the industry stopgap would be acceptable to the Treasury Department. If the industry reaches an agreement on a "stopgap" proposal, we expect to consider it. We continue to believe, however, that our proposal to eliminate the current tax advantages claimed by insurance companies through modified co-insurance corrects a blatant and unintended abuse. The revenue losses are enormous and need to be stopped at once. For these reasons we have issued regulations that will limit the tax benefits that may be realized from the use of coinsurance.

Question 4(a). Please supply the Committee with the Administration's projections, as assumed in the President's budget for fiscal year 1983, for the net investment rate and the savings rate for 1982, quarter by quarter, and 1983, 1984, 1985.

Answer. The Economic Recovery and Tax Act of 1981 was specially designed to spur saving and investment and we fully expect to see a marked improvement in both during the course of the next several years.

1. We expect business fixed investment to average about just under 12 percent of GNP during the three years 1982 through 1984 and to be rising as a share of GNP in the years that follow. This compares with 11.2 percent in 1981 and averages of 11.0 percent for the years 1976 through 1980, 10.5 percent in the decade 1966 through 1975, and 9.7 percent in the decade pror to that. This ratio has been rising over time, and in view of that rising trend, and the incentives contained in last year's tax legislation, the projected ratio for the next few years is clearly not unreasonable.

2. Total gross private saving is expected to average slightly more than 18 percent of GNP in the three years 1982 through 1984, rising to about 19 percent in the later year. Comparable figures for prior years are:

Percent of GNP

1956 to 1965	16.3
1966 to 1975	16.6
1976 to 1980	16.8
1981	16.3

The projected ratios may appear large in historical context but not in context of likely developments over the next several years. The largest portion of the rise in saving is expected to be provided by the business sector reflecting (a) the effects of ERTA, (b) a cyclical recovery in corporate profits, and (c) depreciation thrown off by a rising stock of fixed capital.

3. The personal saving rate is projected to average a little over 6½ percent in the three years 1982 through 1984. This would bring the saving rate marginally above the average for the ten years ending in 1965, but leave it a full percentage point below the average for the following decade. In view of the incentives for saving built into ERTA, this recovery of the personal saving rate must be viewed as modest.

Personal Saving Rate

[Percent]

1956 to 1965	6.5
1966 to 1975	7.7
1976 to 1980	5.7
1981	5.3

The Council of Economic Advisers did not release quarterly or in many cases annual figures with the Economic Report or in conjunction with the 1983 Budget. Many of the series, particularly the personal saving rate, move in a random fashion on a quarterly or even annual basis. The flavor of projected developments is perhaps best captured by the three-year averages cited above.

Question. 4(b). Please supply the Committee with the Administration's estimates of the Federal borrowing absorption rate for fiscal years 1982 through 1985.

Answer. Figures on the Federal borrowing absorption rate during the next several years are not available, as a detailed set of flow-of-funds projections consistent with the economic assumptions underlying the 1983 Budget have not been worked up. However, we do not expect Federal borrowing to place a particular burden on credit markets. It is calculated that Federal deficits, including effects of off-budget requirements, will be roughly 21 percent of the total of gross private saving plus surpluses of state and local governments in fiscal year 1982. That ratio is expected to decline to 16 percent in fiscal year 1983 and to 13 percent in fiscal year 1984. These are as low or lower than during the 1976–78 period when the economy was undergoing a strong recovery.

Federal deficits as a percent of gross private saving plus surpluses of state and local governments

Fiscal year:	
1975	20.6
1976	24.1
1977	15.9
1978	15.7
1979	9.6
1980	16.4
1981	15.8

Question 5. In regard to staffing plans for the Internal Revenue Service, please provide the Committee with the following information:

(a) Details on the staff and dollar reductions, by functions and activity, which took place as a result of the 4,100 personnel reduction in 1981.

Answer. The attached chart shows all the staff and dollar adjustments to the Fiscal Year 1982 budget, by function and activity, from the original Congressional budget submission in March, 1981 through the Continuing Resolution of December, 1981.

INTERNAL REVENUE SERVICE FISCAL YEAR 1982 BUDGET CHANGES FROM THE MARCH 1981 SUBMISSION TO THE DECEMBER 1981 CONTINUING RESOLUTION

[Dollars in thousands]

Program	March 1981 congressional submission		September 1981 reduction		Continuing resolution restoration		December 1981 continuing resolution	
	Average positions	Amount	Average positions	Amount	Average positions	Amount	Average positions	Amount
Executive direction	337	$17,379	−59	−$1,744			278	$15,635
Internal audit and security	948	34,716	−101	−2,766			847	31,950
Management services	761	28,241	−82	−2,393			679	25,848
Legal services	1,731	61,751	−312	−8,626			1,419	53,115
Technical rulings and services	696	26,349	−167	−4,673			529	21,676
Data processing operations	27,075	613,795	−1,698	−33,271			25,331	580,524
Statistical reporting	636	16,533	−45	−801			590	15,732
Taxpayer service	5,155	234,444	−383	−17,814			4,818	216,630
Examinations	28,501	866,095	−909	−27,413			27,592	838,682
Appeals	1,773	63,718		−587			1,773	63,131
Tax fraud investigations	4,191	153,607	+170	+3,155		+$1,200	4,361	157,962
Collection	14,156	380,677	−410	−12,943	+410	+10,800	14,156	378,534
EP/EO	2,041	68,344	56	−2,212			1,985	66,132
Total	88,000	2,565,649	−4,052	−112,098	+410	+12,000	84,358	2,465,551

Question 5(b). Please provide a detailed description of the changes that have occurred or are planned in fiscal years 1982 and 1983 in the Taxpayer Service function as a result of these reductions and the effects thereof expected on taxpayers.

Answer. Summarized below are the staff years and dollars associated with the various components of the taxpayer service function after the September reduction in fiscal year 1982 and as proposed for fiscal year 1983.

Program	Fiscal year 1982		Fiscal year 1983	
	Staff years	Dollars	Staff years	Dollars
Toll-free telephone (including telecommunications costs)	2,839	$89,271	1,122	$44,317
Walk-in/correspondence	574	15,706	588	17,777
Taxpayer education and information (including VITA, tax counseling for elderly)	267	10,803	269	12,304
Miscellaneous taxpayer service	400	13,858	326	11,917
Special program conversion [1]			89	
Information returns program	136	3,401	136	3,577
Disclosure	227	6,121	222	6,301
Problem resolution	108	2,964	108	3,135
Tax forms distribution	267	88,406	267	96,657
Total	4,818	230,530	3,127	195,985

[1] 33 staff-years to fund Teletax, 56 staff-years to fund printing of Understanding Taxes, Small Business Workshop materials.

As a result of fiscal year 1982 budget reduction, it is estimated that approximately 33.9 million telephone calls will be answered, 2.1 million fewer than in fiscal year 1981, and 7.4 million walk-in taxpayers assisted, 1.3 million fewer than in fiscal year 1981. (The walk-in total taxpayers assisted include an estimated 2.3 million taxpayers to be helped through the self-help returns preparation program, which was retained by reprogramming 185 staff years not shown in the above total, as was an additional $0.5 million for reimbursement to Tax Counseling for the Elderly volunteers.) Taxpayer education programs, including VITA and Tax Counseling for the Elderly, taxpayer information programs and related activities remained essentially at fiscal year 1981 levels.

The taxpayer service program in fiscal year 1983 will focus on those essential services which for the most part can only be provided by the Internal Revenue Service, such as account and notice related questions, including refund inquiries, procedural assistance, and seeking the current location of individuals whose refunds have been returned undeliverable. We expect to answer some 12.6 million calls of this type in fiscal year 1983. Quick question walk-in service will also be directed primarily toward answering account and notice related questions. The self-help returns preparation program will be continued, as will direct preparation of returns for handicapped taxpayers or others who demonstrate they are unable to use self-help. In total, we expect to assist about 5.2 million walk-in taxpayers in fiscal year 1983.

Taxpayer information programs, including the public affairs activity will be continued, as will correspondence assistance and all taxpayer education programs except institutes currently conducted for professional tax practitioners. Particular emphasis will be placed on the IRS volunteer tax assistance programs in fiscal year 1983, VITA and Tax Counseling for the Elderly, with reimbursements to volunteers in the latter program discontinued. We plan to expand to all IRS district offices and large posts of duty the Federal Tele-Tax Information Service which is currently being tested in Baltimore and which provides recorded tax information to taxpayers having touch-tone telephones.

Also in fiscal year 1983, IRS will again contract for production of tax information shows for telecast by Public Broadcast television stations and promote the use of Forms 1040/1040A films and cassettes by community/library audiences. Increased emphasis will be given to the IRS sponsored volunteer tax programs in order to provide forms preparation to greater numbers of elderly, low income and other taxpayers with special needs. The Problem Resolution Program will continue in fiscal year 1983 and it is expected to handle approximately 320,000 cases.

In summary, emphasis will be placed in fiscal year 1983 on assisting all taxpayers who must rely on IRS for assistance while allowing the private sector, IRS volunteer tax assistance and tax information programs to meet the tax law needs of other taxpayers.

Question 5(c). Details on the allocation of the 5000 increases in staffing proposed for I.R.S. in fiscal year 1983, and related dollar amounts, by function and activity.

Answer. Separate from all other budget increases and decreases, the Internal Revenue Service has included in the fiscal year 1983 budget a specific proposal to improve tax enforcement.

The following chart indicates the increases by activity, and the anticipated revenue specifically related to this initiative:

Program	Average positions	Cost (in millions)	Purpose	Revenue collected (in billions)
Accounts receivable	+3,030	+$94	Collect unpaid tax	+$1.4
Delinquent returns	+1,000	+27	Secure returns and related tax from non-filers.	+0.3
Examinations	+1,000	+25	Increase audits of upper income taxpayer and businesses.	+0.2
Appeals	+225	+8	Reduce backlogs of cases awaiting administrative settlement (now totaling $11.6 billion).	+0.2
Total	+5,225	+154	Gross revenue	+2.1
			Cost	.2
			Net revenue	+1.9

Question 6. The fiscal year 1983 Budget estimates $1 billion in additional revenues from debt collection activities. In October, 1981, at the hearing held by the Committee on Ways and Means on H.R. 4613 in regard to debt collection, OMB estimated a gain of $500 million annually from the composite of the Administration's debt collection initiatives (No. 97-26, pg. 63).

Please explain this discrepancy and supply us with the details used to arrive at this new estimate in comparison with the information supplied the Committee in October, 1981.

Answer. The President's fiscal year 1983 budget includes total debt collection savings of $4 billion in fiscal year 1983 from administrative and legislative initiatives. These savings can be categorized as follows:

Expected savings

	Millions
Distributed in agency accounts	$1,350
Undistributed (allowances)	1,000
Tax receipts	1,660
Total	$4,010

The $1,350 million in savings distributed in agency accounts represents the amount of delinquent debt expected to be recovered through administrative initiatives already underway in the various Federal departments and agencies. The $1,350 million is distributed in the Budget by agency account, resulting in reduced outlays for each of the Federal departments and agencies which have sizeable delinquent debt.

The $1,000 million in undistributed savings represents two types of savings. Approximately $500 million represents projected savings from enactment of debt collection legislation now pending in Congress. This legislation includes H.R. 4613, H.R. 4614, H.R. 5471 and the complementary Senate Bill 1249. The major savings in these legislative initiatives will come from the redisclosure of IRS addresses, charging of interest and penalties on late payments, and the use of credit bureaus. The remaining $500 million represents Government-wide administrative improvements, including improvements in the litigation of debts owed the Government by the Justice Department, which were not easily assignable in the Budget by agency account.

The $1,660 million of savings in tax receipts reflects a major initiative to recover over $20 billion in reported delinquent taxes. This includes substantially increasing resources dedicated to recovering delinquent taxes and automating collection procedures in order to greatly improve productivity.

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The $500 million in expected savings referred to by Edwin Harper, Deputy Director, Office of Management and Budget in testimony before House Ways and Means on October 15, 1981, related solely to the savings which will result from enactment of the debt collection legislative initiatives now pending in Congress. This legislation includes H.R. 4613, H.R. 4614, H.R. 5471 and the complementary Senate Bill 1249. These legislative initiatives, including H.R. 4613 now pending before your Committee, are essential to a strengthened debt collection program for the Government. Without enactment of this important legislation, these savings will not be realized.

Examples of administrative initiatives already underway in various departments and agencies to improve debt collection practices include:

Loan origination and servicing programs are being examined and made more effective;

Collections officials in agencies are being better trained and held directly accountable for improved debt collection efforts;

The litigation process is being improved to allow for speedier and more effective action against debtors who have the ability to repay but refuse to do so; and

New tools and techniques are being utilized. For example, contracting out certain debt collection functions, such as recordkeeping and billing, to the private sector may make the most sense in instances where the private sector already has greater expertise.

ADMINISTRATION'S FISCAL YEAR 1983 ECONOMIC PROGRAM

TUESDAY, FEBRUARY 23, 1982

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The committee met at 9:35 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman ROSTENKOWSKI. The committee will come to order. I want to welcome you here today. It is always a pleasure to have you join us. We look forward with great interest to your testimony.

I must say that in recent months, regardless of one's view of your policies and those of the Federal Reserve Board, you have conducted yourself with great dignity and consistency. I appreciate that personally.

I want to admonish the members of the committee that Chairman Volcker is here today to speak to us on the issues which confront the Federal Reserve Board. He is not here to discuss the specifics of any particular tax initiative. He is not here to endorse a particular tax program, but rather is here to discuss with us his views of fiscal and monetary policy as it falls within the purview of the Federal Reserve Board.

With that, Mr. Chairman, it is a pleasure to have you with us. We look forward, as we always do, with interest to your testimony.

Mr. Conable is recognized.

Mr. CONABLE. Mr. Chairman, aren't you upset that the Chairman is so limiting your discussion? Wouldn't you like to comment on some of the tax proposals that are coming?

Mr. VOLCKER. At another time, and privately perhaps.

Chairman ROSTENKOWSKI. I think for the first time in his life he is taken aback.

STATEMENT OF HON. PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. VOLCKER. I appreciate this opportunity to participate in your hearings on the President's economic program. The responsibilities of the Federal Reserve are, of course, limited to monetary policy, but we must necessarily recognize the broad interrelationships among monetary and other policies bearing upon national economic performance. Your committee has particular responsibility for initiating specific revenue and spending measures; in reaching your decisions, you must also take into account their implications

for the overall fiscal position of the Government and the implications for financial markets. It is at that point that our concerns intersect, and my comments this morning will be largely directed to that area.

I have often expressed my concern about the critical need to break the inflationary momentum that had come to grip the nation in the 1970's and spoken of the indispensable role that monetary policy has to play in that effort. At the same time, I have emphasized the extra difficulties that result from placing too heavy a burden on monetary policy alone in the fight on inflation—difficulties manifested in exceptionally heavy pressures on financial markets and interest rates, and therefore on credit-dependent sectors of the economy.

Current developments both reflect needed progress on the inflation front and reinforce my concern about the burdens placed on monetary policy to bring about and sustain that progress. In the best of circumstances, ending an inflation, once it has become embedded in behavior and expectations, can be painful in the short run, however necessary that effort is to our future strength and prosperity. The hard fact is the economy is now in the grips of a second recession in as many years. Recent developments have some of the characteristics of earlier cyclical downturns. But the current recession has been superimposed on a pattern of stragnation extending over a number of years—years characterized by a rising trend of unemployment, lagging productivity, and particularly strong pressures on the older industrial sectors and regions. And, even now, after months of rising unemployment, interest rates have remained painfully high, delaying recovery in some important sectors of the economy.

In broad terms, I don't think there is any great mystery as to why the economy and financial markets have behaved in this way. During the 1970's, inflation increasingly became viewed as a way of life, and in the process economic incentives were distorted and our productive energies sapped. As we lost our most important financial yardstick—a stable dollar—interest rates rose and became highly volatile. As monetary policy moved to deal more forcefully with the inflation, particularly in a context of fiscal imbalance, the strain on financial markets became more acute. But the alternative course of trying to accommodate to inflation by providing excessive monetary growth would offer no lasting relief, and probably little respite even in the short run, for that approach would only feed inflationary expectations and reinforce the reluctance of lenders to commit funds for any substantial period of time ahead.

Now we can see clear signs of progress on the inflation front. A reversal of the pattern of the inflation rate ratcheting higher in each successive economic cycle would be an event of profound importance, not least in encouraging a return to much lower and more stable interest rates. We cannot "prove" that we have yet turned that corner. Indeed, some of the progress against inflation reflects the more immediate and temporary effects of recession-weakened markets, the pressures of extraordinarily high interest rates on commodity and other sensitive prices, and recent surpluses in petroleum and grain production. But we are also seeing signs of potentially more lasting changes in attitudes of business

and labor toward pricing, wage bargaining, and productivity. Not surprisingly, the effort is most clearly apparent in industries where costs and wages have been most out of line, where international competitive pressures are particularly intense, or where regulatory change has encouraged greater price competition. But, I believe the pattern is likely to spread, "building in" lower rates of increase in nominal wages and prices over time. And, as the inflationary and cost pressures ease, the economy can resume a healthy growth pattern, with greater job opportunities, increasing productivity, and higher real wages.

But if that bright prospect is to be achieved, we simply cannot afford now—just as the disinflationary process is beginning to take hold and beginning to be believed—to abandon our monetary vigilance. Past failures to "carry through" have left a legacy of skepticism and uncertainty among workers and businessmen, among consumers and among participants in financial markets where lenders demand "inflation" and "uncertainty" premiums when committing their funds. Credibility in dealing with inflation will have to be earned by performance and persistence over time. Prudent fiscal and other policies must help in achieving that credibility. But I believe it is broadly and rightly recognized that, whatever those other policies, appropriate restraint on the expansion of money and credit will continue to be fundamental to restoring price stability.

As you know, I testified 2 weeks ago before the House and Senate Banking Committees to report the Federal Reserve's specific intentions with respect to money and credit growth for 1982. Without repeating the details, I'd like to highlight a few of the major points.

Developments during 1981 were broadly consistent with the continuing effort to reduce growth of money and credit to noninflationary levels over time. There were, to be sure, some divergent movements among the various monetary and credit aggregates that we target. Those movements are largely explicable in terms of technological and regulatory change—the introduction of NOW accounts nationwide, the enormous growth of money market funds, and other factors affecting the preferences of the public for different types of financial assets. Specifically, M_{1B} growth—adjusted for the estimated shift of funds into NOW accounts—decelerated further last year, averaging, over the year as a whole, a little more than 1 percent below the previous year—the third consecutive year of lower growth. From the fourth quarter of 1980 to the fourth quarter of 1981, M_{1B} growth—adjusted—was 2.3 percent, a little more than 1 percentage point below the lower end of the target that we had indicated was desirable at mid-year. The growth of the broader aggregate M_2—about 9½ percent over the four-quarter period—was a bit higher that in 1980, partly reflecting the extraordinary growth in money market funds.

As you know, the money supply increased particularly sharply in the early weeks of 1982, following fairly large increases in November and December. Increases of that size are unusual when production and incomes are weak, and the recent rise appears to be related in considerable part to the desire of individuals to place marginally more of their assets in highly liquid form. Interest rates, after falling sharply last fall, retraced part of that decline in January

and early February, partly because the rising money supply was reflected in renewed pressure on bank reserve positions. More recently, monetary growth appears to be moderating, and bond markets have rallied.

These recent movements, in my mind, emphasize again two relevant points in assessing our monetary targets and their implications. First, in a large and complex economy, short-term fluctuations in money supply data—for a month or even a quarter, and much more so from week to week—can be anticipated as consumers and businesses adjust their cash holdings. So long as the trend is appropriate, those short-term fluctuations should have no important implication for economic activity or inflation.

Second and more fundamentally, our targets are, by design, limited to amounts necessary to finance real growth in a framework of declining inflation. The stronger the inflationary momentum, and the more pressure on credit markets from other directions, the greater the risk that high interest rates will squeeze out housing, investment, and other private activity supported by borrowing.

We believe the targets for 1982 established this month—reaffirming tentative targets set out last July—will be consistent with recovery in business activity over the second half of the year. Our target range for M_1 of 2½ to 5½ percent is consistent with growth in money over the year as a whole larger than during 1981, and the Federal Open Market Committee has suggested that, as things now stand, growth in the upper part of the range would be acceptable. The FOMC also suggested M_2 growth toward the upper end of its 6- to 9-percent range, the same as last year, would also be acceptable. But these ranges also imply a "tight fit," in the sense they are predicated on the assumption and the prospect of a further decline in the rate of inflation.

The fact is that consolidating and extending our progress on inflation will require continuing restraint on monetary growth, and we intend to maintain the necessary degree of restraint. That restraint, by providing assurance that inflation will continue to decline, should over time be a powerful influence in bringing down interest rates as well, particularly in the long-term area. Indeed, prospects for any lasting relaxation of interest rate pressures would dim without the continuing monetary discipline that success against inflation requires.

For the more immediate future, interest rate prospects depend crucially on other factors as well, and I am fully aware that interest rates are vitally important to the timing, strength, and sustainability of economic recovery. The most important of those other factors is surely the outlook for the Federal deficit, and it is a factor directly within your own purview.

As you know, this year, fiscal 1982, we will have a very large Federal deficit—on the order of $100 billion. To a considerable extent, that deficit is a reflection of the recession, as it reduces revenues and raises outlays. In the particular circumstances of today, the current deficit, to a large degree, acts as an "automatic stabilizer" for the economy. The financing load should be manageable in a context of reduced credit demands by other sectors.

As we look ahead to 1983 and beyond, the situation is quite different, and that is the source of my concern about the budgetary

situation. What is so disturbing is that the current services budget—taking account of the administration's defense program—shows a sharply rising deficit, even if we assume revenues are lifted and spending restrained by rather strong recovery. All the estimates before you, by the administration, by the Congressional Budget Office, or by private forecasters, point in the same direction. In the absence of action to close the potential gap, the deficit will rise to about $150 billion or more in fiscal 1983, and to still larger amounts in later years. Looking at the same situation in another way, even if we assumed the unemployment rates would soon drop back to 6 percent or so—about the level of the best recent years—we would be faced with large and rising deficits unless strong new measures are taken to contain them.

In recognition of this outlook, the administration has, as you know, proposed substantial measures to reduce the potential deficit for fiscal 1983 and the years beyond. The emphasis is on spending reductions, but some revenue measures are also proposed. That program is estimated to reduce the projected fiscal gap by $56 billion in 1983 and $84 billion in 1984. If enacted as proposed, it would go a very considerable way toward dealing with the fiscal problem.

As you consider those and other proposals, I must emphasize the threat that, unless substantial budgetary actions are undertaken, private borrowers would be squeezed out of the market, with adverse consequences for homebuilding, for business investment, and for other credit-dependent sectors. In other words, the budgetary outlook, as it stands, does not seem to me consistent with the expansion in private investment we seek, and have sought to encourage through tax reduction and other measures.

The problem is not simply one for the future—for 1983 and 1984 and beyond. Financial markets constantly look ahead. Any lender or borrower tries to anticipate and "discount" what lies ahead. Anticipations of a future "squeeze" are translated into present high interest rates, into a desire to "stay short" in lending, into a reluctance to set into motion plans to build and to invest. Moreover, the deep-seated public instinct that sustained large deficits will lead, sooner or later, to pressure to create more money to finance those deficits, or will otherwise stimulate inflation, undercuts the effort to restore stability.

I would also point out that even with measures as large as those proposed by the administration we would be left with historically high deficits in relation to GNP or our probable savings potential as the projected recovery proceeds. And those projections have little margin for misjudgment of the underlying trend in spending or revenues, in interest rates, in the inflation rate and the like—areas where any projection has an element of uncertainty. I note, in that respect, that projections of the existing budgetary gap by the Congressional Budget Office run somewhat higher than those of the administration.

The potential for continuing squeeze on financial markets could be alleviated by increases in business and personal saving. Such savings has been abysmally low in recent years. Greater price stability, positive real interest rates, and the tax measures introduced last year all should work in the direction of greater savings. But to count on a dramatically large increase in savings to "bail" us out

of the budgetary problem would be to miss the point, at best. We need larger saving to finance higher levels of business investment and housing construction; we cannot afford to have it dissipated in financing prolonged excessive budget deficits—deficits that, as matters stand, would absorb, or more than absorb, a reasonable projection of increased savings.

Given the nature of the problem before us, and the clear risks of underestimating the size of the budgetary problem, I can only conclude that the Congress should set its sights for still larger budgetary savings, keeping in mind the widening gap now projected beyond fiscal 1983.

Credible steps to assure substantially declining Federal deficits as the economy expands, looking toward balance as we restore satisfactory levels of unemployment, would be enormously helpful in resolving some of the problems in our financial markets today. Indeed, such action could have a galvanizing effect in bringing about lower interest rates because it is concern about the budgetary prospects that preoccupies the thinking of many potential investors in the market today.

In carrying the primary responsibility for originating tax legislation and for certain large spending programs, your committee has the excruciating job of translating general budgetary objectives into concrete legislation. You must make choices involving social, national security, and programmatic considerations far beyond the purview of the Federal Reserve or my competence. As a purely economic matter, I do believe that, in general, lower taxes—particularly lower marginal income tax rates—will permit the private economy to perform more effectively, tending to increase incentives and reduce distortions. From that standpoint, spending control clearly deserves priority. But to the extent the needed job cannot be done by expenditure control alone, I see no alternative to considering new sources of revenue.

The difficult economic circumstances of today should not blind us to the fact that we have much upon which to build. We can see the tangible progress against inflation. The administration and the Congress have taken action to spur productivity, work, and savings through the tax system. The inexorable upward trend in spending has been bent lower. Regulatory reform is underway.

From that perspective, what we need is not any basic change in direction, but a sense of urgency and persistence in "carrying through." That has clear implications for continued discipline in monetary policy. And it has direct implications for dealing with the budgetary problem that looms so large before you.

Seldom, in my experience, has the challenge been so clear for all to see, and seldom has there been so strong a consensus on the need to meet it with bold measures. It is those facts which give me confidence that you and your colleagues, working with the administration, will find the way to reconcile the competing priorities among the particulars of spending and revenue decisions in a way consistent with needed reduction in the deficit. The quicker that can be done, the brighter, in my judgment, will be the outlook for the economy.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Thank you, Mr. Chairman.

Mr. Chairman, many of us are concerned about the possibility of widespread insolvency among financial institutions, particularly savings and loan associations and mutual savings banks. There is even some threat that outright failures of such institutions may swamp the resources of the FDIC and the Federal Savings and Loan Insurance Corporation.

Do you share these concerns and what contingency plans, Mr. Chairman, are being developed at the Federal Reserve Board to cope with this potential situation?

Mr. VOLCKER. I certainly share your concern about the pressures on thrift institutions, in particular. Those institutions, by and large, are running very substantial losses at present levels of market interest rates because they are locked into a great many mortgages at much lower interest rates acquired in earlier years.

I think the situation is one of great pressure on those institutions and the result is going to be, I am afraid, a good many mergers or consolidations of those institutions, as we have seen beginning in recent months. I do think the situation is manageable, in the sense that direct resources of the FSLIC and the FDIC can be brought to bear to deal with situations and with individual institutions that may become insolvent, as has been the case recently.

We have proposed some legislation, which the House passed last year, you may recall, to facilitate dealing with this precise situation by easing the possibility of mergers with commercial banks, where that may be necessary and desirable. We had a situation like that yesterday, of injecting capital where the institution is basically viable and could be helped over a period of time by that approach.

The basic solution to this problem lies only in a lower level of interest rates. In one sense, the problem is transitional. As those institutions can roll over their assets at current interest rates they can return to profitability. But that takes quite a bit of time in the case of a thrift institution, so the much more promising answer to their problems, of course, is the decline in current market rates, and it is an important aspect of the urgency with which we need to undertake policies that do have the promise of reducing market interest rates.

Chairman ROSTENKOWSKI. Mr. Chairman, are you anticipating making any more recommendations with respect to legislation? Is there anything you would like to share with us today with respect to what we can do as a tax-writing committee?

Mr. VOLCKER. I do not have any legislation to recommend today, Mr. Chairman. I would still like to see a so-called regulators' bill passed, but that is not up to you. It has passed the House. Some modest rewriting of that bill to update it in the light of the present situation is possible, but, as I indicated, it does provide some opportunity for capital infusion, at least in selective cases, where particular institutions could be helped—and properly helped—by that particular technique.

Chairman ROSTENKOWSKI. Mr. Chairman, I have a question on business investment. In your view, why has business investment failed to respond to the tax incentives that were enacted last year?

Mr. VOLCKER. You have a troubled economy out there at the moment. The economy has not been expanding rapidly. There is a

certain amount of excess capacity at the moment, which is generally not good for large increases in business investment, and you have very considerable pressures on financial markets.

I think there are investment incentives, in terms of legislation that was passed last year. Certainly there is major tax relief for corporations and businesses through that legislation. But, in the short run, the economic circumstances push in the other direction, so you have, more or less, a standoff.

Chairman ROSTENKOWSKI. Mr. Conable will inquire.

Mr. CONABLE. Thank you, Mr. Chairman.

Mr. Chairman, do you recall any time when there has been as big a spread between the rate of inflation and long-term interest rates as there is now?

Mr. VOLCKER. Yes, I am afraid that this is not as uncommon as some folklore suggests. I could put some material in the record.

I think it is fair to say that if you look at the current rate of inflation—today's rate of inflation or last month's rate of inflation—and compare it to current interest rates, the gap is wider in nominal terms now that it has averaged over a long period of years; that is quite clear.

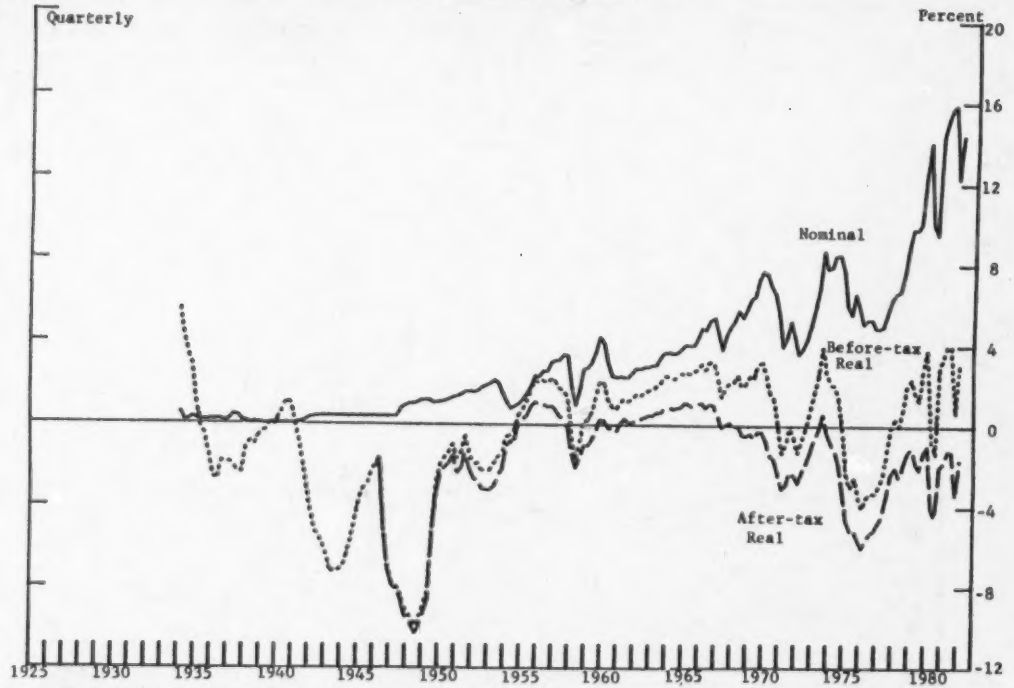
But there have been periods in the past when you have had high real interest rates of this sort. When you are talking about a real interest rate you are talking about a concept, not a statistic. The proper comparison is what people think the inflation rate will be, which is not perfectly measurable; you have the difficulty of trying to get a statistical measurement of a concept that cannot be measured.

The fact is that that relationship has fluctuated quite a lot over time. More typically, in recent years, the relationship has been negative, if you compare the actual inflation rate with the interest rate.

[Chairman Volcker subsequently submitted the following information for the record:]

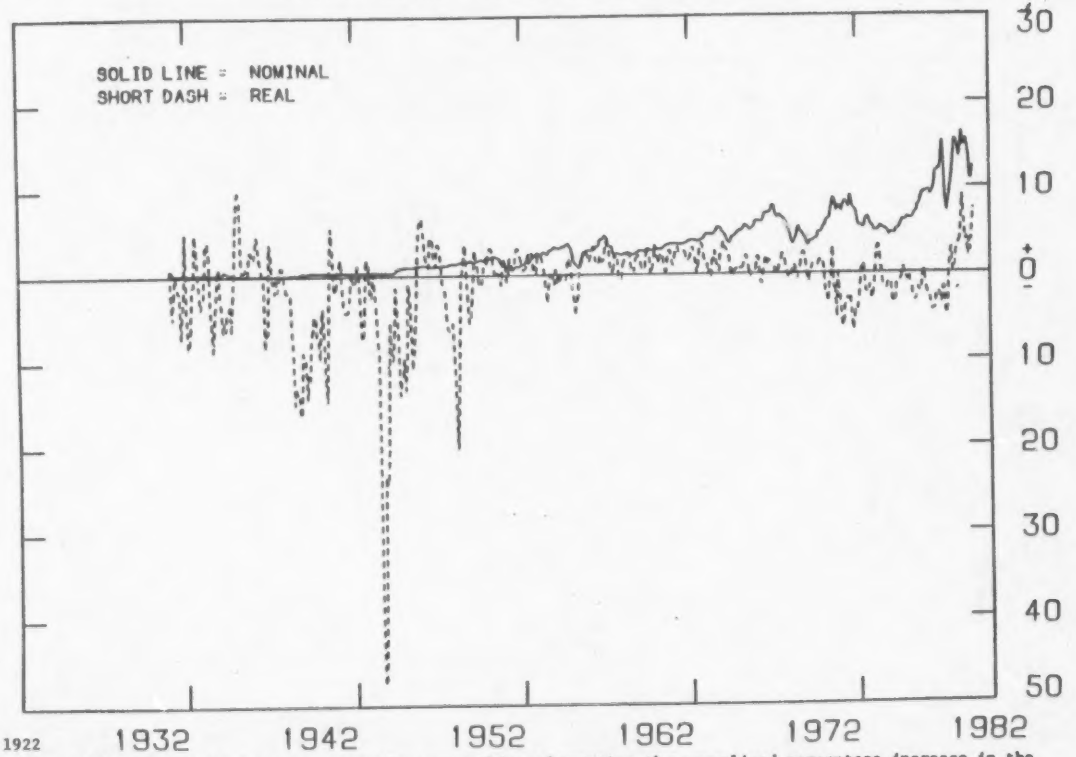
The attached charts depict the behavior of "real" interest rates over the past 50 to 60 years. The measure of inflation expectations, which must be deducted from the observed nominal interest rate, is based on the actual behavior of consumer prices in the recent past. It will be observed that, although the present level of real rates is relatively high, that level has been equaled or exceeded in prior periods. Moreover, the recent bout of high real rates has been a brief one, thus far. In addition, for many borrowers, the effective after-tax cost of credit is not as high on a comparative basis as it has been at many times in the past when tax rates were lower.

NOMINAL, BEFORE-TAX REAL, AND AFTER TAX REAL INTEREST RATES[1]
Three-Month Treasury Bill



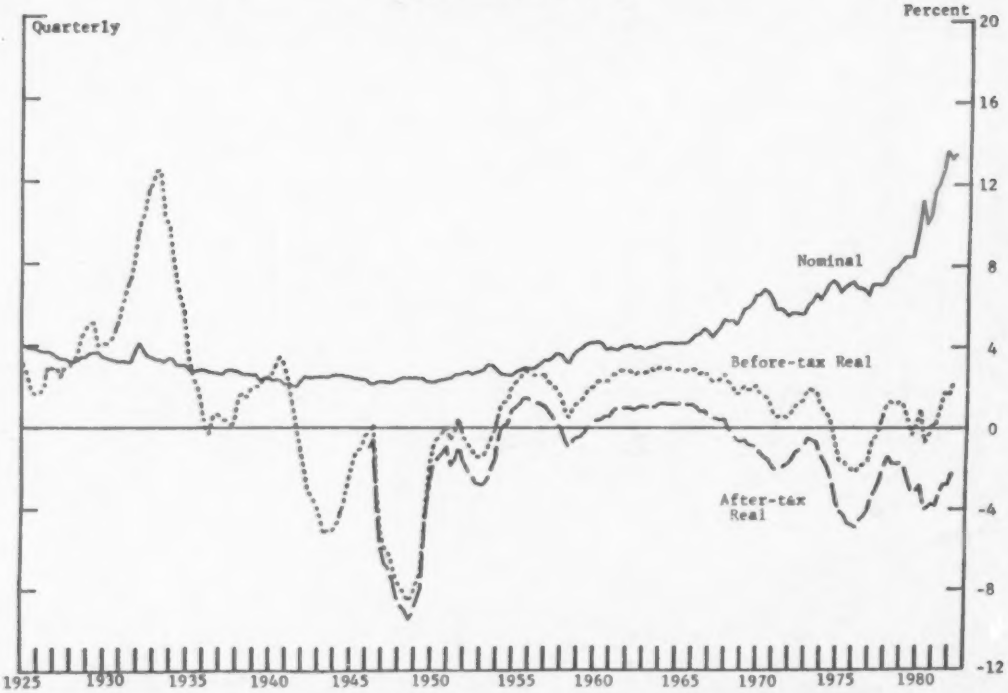
1. The before-tax real interest rate is the difference between the nominal interest rate on three-month Treasury bills (measured on a coupon equivalent basis) and the expected rate of inflation, where the latter is computed as a 12-quarter moving average of actual inflation rates (using the Consumer Price Index). The after-tax real interest rate is computed by subtracting the expected rate of inflation from the after-tax nominal interest rate, where the latter is given by the product of the nominal interest rate and 1 minus the tax rate. The tax rate used here is the effective corporate income tax rate on a NIPA basis.
2. Latest date plotted is February 18, 1982.

NOMINAL AND REAL INTEREST RATES
THREE MONTH TREASURY BILLS



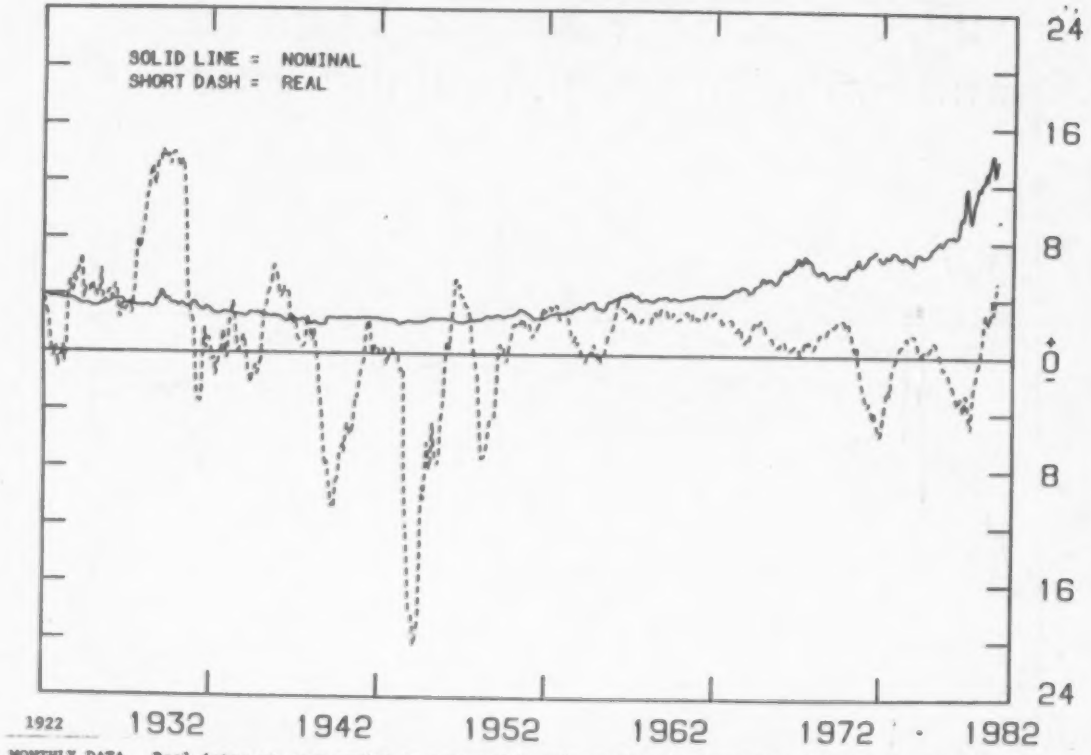
MONTHLY DATA. Real interest rate series is computed by subtracting the annualized percentage increase in the Consumer Price Index during the preceding three months from the nominal coupon-equivalent Treasury bill rate.

NOMINAL, BEFORE-TAX REAL, AND AFTER TAX REAL INTEREST RATES[1]
Long-Term Treasury Bond



1. The before-tax real interest rate is the difference between the nominal interest rate on long-term Treasury bond and the expected rate of inflation, where the latter is computed as a 12-quarter moving average of actual inflation rates (using the Consumer Price Index). The after-tax real interest rate is computed by subtracting the expected rate of inflation from the after-tax nominal interest rate, where the latter is given by the product of the nominal interest rate and 1 minus the tax rate. The tax rate used here is the effective corporate income tax rate on a NIPA basis.
2. Latest data plotted is February 18, 1982.

NOMINAL AND REAL INTEREST RATES
LONG TERM TREASURY BONDS



MONTHLY DATA. Real interest rate series is computed by subtracting the percentage increase in the Consumer Price Index during the preceding twelve months from the nominal long-term Treasury bond interest rate.

Mr. CONABLE. I have heard it said here in Congress by some elements that one of the reasons the long-term interest rate is not more responsive is because of the very high cost of money as a result of the competition for money going on in money market securities and things of that sort, as opposed to the major source in the past having been savings accounts. Now is there anything to that argument?

Is there a tendency for banks to keep their interest rates higher than they normally would because they are having to pay a lot for the money, or is it regulated almost entirely by competitive factors?

Mr. VOLCKER. In general, it is responsive to competitive factors. Perhaps the point you are alluding to is a point that some economists make, that in the days when we had interest rate ceilings that were binding—we still have some interest rate ceilings, but there are a lot of ways to pay market rates—we had pressures on the money markets. Interest rates paid by banks and thrift institutions could not go up because they would run into the interest rate ceiling, so money would be diverted from those institutions, which had effects on the housing industry and on other sectors in the economy to which they lent money. You had a so-called "credit crunch": the economy slowed down, and interest rates stopped rising.

I think there is something to the proposition that if you put ceiling rates of that sort on, the level of interest rates would be lower. However, the economy may not perform very well either.

Mr. CONABLE. I understand. Thank you.

Chairman ROSTENKOWSKI. Mr. Pickle will inquire.

Mr. PICKLE. Thank you, Mr. Chairman.

Mr. Chairman, we read in the paper that you and President Reagan have kissed and made up. That is, he has endorsed the Federal Reserve's policy and will work with you. I wonder if you have endorsed his fiscal policy? More specifically, do you recommend that we have no decrease in defense spending at this point and no deferment of the third year individual tax cut? Or, do you think we should make changes in those areas?

Mr. VOLCKER. I have expressed the opinion before, and I expressed it again this morning, Mr. Pickle, that you have a very large budgetary problem before you, that the President's program takes a large chunk out of that deficit, but if I had my druthers you would go beyond that in the amount of deficit-cutting, looking ahead to 1983, 1984, and beyond.

So I would like to see a bigger program.

Mr. PICKLE. You would make more cuts in the budget?

Mr. VOLCKER. Yes. Now when it comes to what areas of the budget to cut, or which sources of revenue to look toward, I think you enter into a series of considerations that really go beyond my desire or competence to comment on.

You mentioned the defense program. Obviously that involves considerations of just how much money is necessary for a strong defense. I haven't got any particular competence in that area. That is the kind of judgment you have to make.

Mr. PICKLE. Mr. Chairman, if you would recommend deeper cuts in the budget, then defense would properly be one area we would

have to consider, although you may not know the exact ingredients to be concerned with.

Mr. VOLCKER. I think it is appropriate and desirable for the Congress to look at every area. That is your job.

Mr. PICKLE. I notice that you said that in addition you also say that there is no alternative except new sources of revenue. I wonder what you mean by "new sources of revenue". Is that new taxes, new money raised from different sources? Or could "new sources of revenue" mean a deferment of a third-year tax in some way? What do you mean by "new sources of revenue"?

Mr. VOLCKER. I think any of those.

Mr. PICKLE. Can you tell me what effect the IRA's—the Individual Retirement Accounts—have had with respect to new sources of money or the supply of money? Has there been a significant amount of savings or a particularly significant amount of new money brought about by the IRA accounts?

Mr. VOLCKER. I certainly cannot answer that now; it is too new, Mr. Pickle. We will be collecting figures on that as time passes. We have made some arrangements to gather information on the total amount of money put in IRA's, at least in financial institutions. Even then, it is hard to make a judgment as to how much of that is new savings, as compared to how much is a transfer from another source.

Mr. PICKLE. It is relatively new, but we need to have a good accounting. I am going to address the question to all my banks, savings and loans, credit unions, and insurance companies in my district and try to find out how much new money is being raised, because it is important.

Mr. VOLCKER. We will be collecting data, but it is going to be difficult to identify how much of that is new.

Mr. PICKLE. Another area that we need to concern ourselves with, is the Federal Reserve's function of providing the business community with basic data on money supply.

Specifically, in that area, is the question of money market funds. A great deal of money is going from the savings and loan and the banks into Merrill Lynch, to the extent that most people say now the only bank we are going to have left in 10 years is Merrill Lynch. Everybody else will be working for them.

I do not know whether that is so or not, but it is an interesting point. Do you think that the money market funds should be brought within the framework of the Federal Reserve? Should they be regulated in some respect?

Mr. VOLCKER. Yes, we have made some proposals to that effect and suggested that Congress should consider an arrangement whereby, to the extent that a money market fund is operating a checking account business, that such balances bear the same reserve requirement as is placed on a financial institution running a checking account business.

We also suggested that, to the extent a money market fund is not running a checking account business, there might be a notice requirement on withdrawing the funds to make a clear distinction between what are so-called "transactions balance" and what deposits are in the nature of savings.

I think it is fair to say from analysis of the money market funds that the great bulk of that money is analogous to savings account money or short-term time deposits. It is liquid, to be sure, but a form of savings rather than money in the narrow sense, although there is a growing element of money in it pure and simple.

Mr. PICKLE. Yes, there is. And aren't we caught in a conflict of concerns here that if we put some restraint on growth of the money market funds, then we are regulating them. We are trying to get away from regulation in every aspect, so we have to decide which way to go.

Mr. VOLCKER. Yes. That is the dilemma.

Mr. PICKLE. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Rangel will inquire.

Mr. RANGEL. Thank you.

Mr. Chairman, what relationship do you see between our recently-passed tax reduction and the increase in military spending with the current deficit?

Mr. VOLCKER. Arithmetically, of course, the decrease in revenues and increase in defense is a large contributor to the widening budgetary gap.

Mr. RANGEL. And had we made substantial changes in either side of that, the economy would have had an entirely different complexion—a lower deficit and probably unemployment would be much lower today, would it not?

Mr. VOLCKER. I do not know about the latter. You would have a lower prospective deficit. Those programs have not had a substantial impact on the order of magnitude on the deficit today.

Mr. RANGEL. I do not want you to go beyond whatever political restrictions you have, but I am talking about this supply side economics the Congress went through and the resulting sharp decrease in revenues. Would you not say that has substantially contributed to the deficit that we are experiencing today?

Mr. VOLCKER. No. I think it contributes to the deficits that we are looking at ahead. I do not think it has had a big impact on the current deficit.

Mr. RANGEL. Well, every witness we have tells us that we have to go through this painful experience of tight fiscal policy, cutbacks in spending, and raising revenues, or at the very least, delaying some of the tax reductions. Does your Board collect any information on the number of small businesses that, as a result of your policies and this Administration's policies, have gone bankrupt and will not be able to recover from this painful experience the Nation is going through?

Mr. VOLCKER. We do not collect independent statistics. We observe statistics that other people collect without accepting, necessarily, the causation that you referred to.

Mr. RANGEL. I am talking about the causes. They just cannot get money, their Government is competing in the money market, the larger enterprises are in a better competitive position; they are on the rise, they are increasing, they are hiring people. We see them every day in our districts, and they are saying that as a result of the high interest rates, their dreams are shattered, not just for themselves but for their families.

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And everybody testifies about how rough it is going to be for us, but "us" seems to be a certain class of people. The beneficiaries of the tax reductions do not seem, Mr. Chairman, to be suffering at all—except perhaps psychologically. But I do not see the list of witnesses here talking about the suffering of the wealthy, or the large enterprises. And I see smaller businesses going out of business every day.

This committee went to Seattle. A man told me he had hired 14 people. Two of them were his brothers that quit their jobs to join him. He was in the housing industry. Due to high interest rates—it's not just him—he was concerned about the 14 employees that are now out of business. Yet every witness says we have to go through this painful experience without anyone talking about giving any assistance to these Americans that have given up so much to make the country as great as it is today.

Mr. VOLCKER. It is clear that many small businesses are under very heavy pressure. Bankruptcies are up quite sharply, and in good part that is related to general economic conditions, in which interest rates play a part.

I would urge upon you—in terms of your responsibilities and to the extent those problems arise because of pressures in credit markets—that the prospective size of the Government deficit contributes directly to the availability of money to small businesses.

Some smaller businesses, some farmers and, particularly, homebuilders, and home buyers, are the weakest participants in the credit market, and they are very heavily dependent upon the credit markets. The strongest participant in the credit markets is the Federal Government. The more the Federal Government takes, the less there is left over for those other, weaker, sectors.

That is what this problem is all about and the point that I am trying to urge upon you is that to the extent we can get the Federal Government out of the way in the credit markets, those sectors are going to benefit directly.

Mr. RANGEL. But can you not come up with any ideas for short-term relief for these victims of the changes in the economy?

Mr. VOLCKER. It is very difficult to devise methods of short-term relief. You are chasing your tail if those measures of short-term relief entail more budgetary problems.

I think the best short-term relief we can give them is consistent with the long-term relief of dealing with this deficit problem.

Chairman ROSTENKOWSKI. Mr. Duncan will inquire.

Mr. DUNCAN. Thank you, Mr. Chairman.

Mr. Chairman, some advocate restrictions on borrowing to bring about mergers of large corporations. What are your views on that proposal?

Mr. VOLCKER. It is a very difficult practical problem. Assuming that was a good idea, how would you really limit access to credit effectively when you are dealing with some of the biggest and strongest companies in the United States who can borrow through the banking system, who can borrow outside the banking system, and who can borrow abroad? It would be a very difficult job to deal with that problem effectively.

The other part of the equation is how important is it? What good does it do you? It is easy to demonstrate, in general, that however

spectacular some of these deals look, the amount of credit that ultimately is involved may not be as large as it looks on the surface. What happens in these cases, typically, is that a large amount of money is, indeed, borrowed, but then is paid over to the existing owners of the company that is taken over, who presumably put that money back in the market.

You have to do some balancing when you look at the total transaction. You are left, I think, with some effects on the distribution of credit, some effects on the demand for bank credit, in particular, but I don't think you can just add up the total amount of money borrowed for these deals and say that that money is in some net sense taken out of the market.

Mr. DUNCAN. Are you monitoring that at the bank?

Mr. VOLCKER. We try to watch it, yes.

Mr. DUNCAN. Do you have a report on it?

Mr. VOLCKER. I don't have a report. We could give you a list of some of the larger financings that we are aware of.

Mr. DUNCAN. I am amazed that you do not already have information on that.

Mr. VOLCKER. We have a list of that sort.

Mr. DUNCAN. Could you provide the committee with a report on that subject?

Mr. VOLCKER. Yes.

[Chairman Volcker subsequently submitted the following information for the record:]

NOTE ON MERGER/ACQUISITION FINANCINGS

The accompanying list summarizes developments with respect to some of the major bank credit arrangements made last year in connection with merger and acquisition activity. As the list makes clear, the reported loan commitments greatly overstate the magnitude of actual borrowing activity, and a large share of the commitment/lending activity involved banking offices abroad. Moreover, bank loans have frequently provided only short-term "bridge" financing. The impact of takeover loans on changes in domestic commercial credit was noticeable in some months, but over 1981 as a whole the net impact was very small.

A SUMMARY OF LARGE CORPORATE MERGER/ACQUISITION FINANCINGS IN 1981–82

Fluor

Arranged a bank credit line for takeover of St. Joe Minerals. Overall size of line was not reported, but Fluor took down a $1 billion loan, all from U.S. banks: [1] no repayment yet reported.

Conoco

Arranged $3 billion bank credit line, $2.4 billion of it with U.S. bank. Line was arranged for possible defensive purposes and evidently was not drawn upon.

Mobil

Arranged a $6 billion bank credit line, one-third of which was with U.S. banks. It took down $6 billion, of which $1.65 billion was from U.S. banks, in July but repaid all in August when it failed in its Conoco takeover attempt. It borrowed an estimated $0.2 billion from U.S. banks in November (total loan was $4 billion), at which time it was involved in an unsuccessful attempt to acquire Marathon Oil; no repayment has been reported.

Texaco

Arranged a $5.5 billion bank credit line for takeover purposes, initially with Conoco as the target. No actual borrowing is reported.

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[1] "U.S. banks" refers to domestic offices of U.S. banks plus U.S. branches and agencies of foreign banks. This is the scope of the banking system in the Federal Reserve's bank credit series.

DuPont

Arranged a $4 billion bank credit line; took down $2.5 billion from U.S. bank in acquiring Conoco and then repaid the bulk in the fourth quarter with the proceeds of market borrowings. Repayment of the last $0.9 billion of the loan has not been reported.

Cities Service

Arranged a $4 billion credit line for defensive purposes; no borrowing is reported.

Marathon

Arranged a $5 billion credit line for possible defensive uses; $1.2 billion was taken down at U.S. banks (total loan of $5 billion) but repaid after agreement with U.S. Steel.

Pennzoil

Arranged a $2.5 billion credit line for possible acquisition purposes; no takedown reported.

Gulf Oil

Arranged a $6 billion bank credit line for possible acquisition; no borrowing reported.

U.S. Steel

Arranged a line of just over $4 billion; only $0.3 billion was borrowed at U.S. banks (total loan, $3.2 billion) in connection with the Marathon acquisition and this has not been reported repaid.

Mr. DUNCAN. You state, on page 10, that we need larger savings to finance higher levels of business investment and housing construction. What would you suggest to the Ways and Means Committee that we should do to achieve higher levels of savings?

Mr. VOLCKER. I do not have any particular proposal of that kind. You took a lot of measures last year, and I think it is appropriate to see how they work. I do not have any bright new measures to suggest to you. I think the main priority is to work on the other side of that equation, to reduce the Government deficit that is going to absorb so much of that savings.

Mr. DUNCAN. Many persons are, at one time or another, attracted to the idea of replacing our current graduated tax system with a flat, across-the-board tax on all income. Would you care to express yourself on that subject?

Mr. VOLCKER. An income tax——

Mr. DUNCAN. Across the board, yes, sir—just a flat tax to all income.

Mr. VOLCKER. I do not have any particular comment on that. I haven't analyzed it closely.

I would say, however, that this country has put a lot of emphasis on direct taxation and direct, aggressive income taxation. From the standpoint of the operation of the economy, I have some question as to whether we haven't gone too far in that direction and whether some broadly based taxes, perhaps of the indirect character, might not achieve a better-balanced tax structure; we have placed so much weight on the progressive income tax.

Mr. DUNCAN. Do I understand you to say that we have gone too far?

Mr. VOLCKER. I think we had, particularly before the tax reduction bill last year. My feeling is that we probably would have been better off with perhaps more indirect taxation and a little less direct income taxation.

Mr. DUNCAN. One other short question. Do you agree with Secretary Regan yesterday when he said that he expected the savings rate to rise substantially during the next several years?

Mr. VOLCKER. I would expect it to rise some, yes. It has been very low. I don't know the precise number he had in mind, but I would expect the rate to go up. I do not think that we should assume such a dramatic increase as to relieve our concerns about budgetary deficits.

Mr. DUNCAN. Thank you, sir. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Downey will inquire.

Mr. DOWNEY. Thank you, Mr. Chairman.

Mr. Chairman, if I said to you that deficits do not cause high interest rates and that the historical record shows no direct association of deficits and interest rates, would you say that that is an accurate statement?

Mr. VOLCKER. If you look at it on a year-by-year basis you would not see much direct relationship. The dominant influence on fluctuations in the deficit over time is the state of the economy. If you have a recession, you have a higher deficit, as this year. Typically you also have lower interest rates during recessions.

That does not, in my judgment, at all detract from the basic point, that the higher the deficit, other things being equal, the higher interest rates will be and the more demand there will be on savings; it is just that that relationship in any historical series is obscured by a lot of other powerful forces at work.

Mr. DOWNEY. So your statement before the Banking Committee that the current high deficit projections are directly inimical to the kind of progress we want to see, both in the economy and with respect to interest rates, and that those factors are intertwined is basically what you are testifying to here today?

Mr. VOLCKER. Yes.

Mr. DOWNEY. Can I ask you some questions about the velocity of money? The administration proposes in the next several years that the velocity of money will be approximately 6 percent, which is an historic high level. Do you anticipate the velocity of money being that high?

Mr. VOLCKER. Velocity of money is not easy to project. Historically, those would be high levels to sustain.

Mr. DOWNEY. Would you call that prediction unrealistic?

Mr. VOLCKER. I think it would depend, frankly, upon whether the kinds of changes we have seen in the past year or two in technology continue rapidly. The rise of money market funds that was referred to is an important factor in that development.

If we do not count money market funds as narrow money, but yet more and more people find it convenient to keep what is functionally money in the form of a money market fund, you can get rapid increases in velocity.

Mr. DOWNEY. So it is possible, then, to have a 6-percent rate of velocity for money, but not probable?

Mr. VOLCKER. I would think not probable unless rapid technical change continues.

Mr. DOWNEY. Let me ask you a question about the probable impact of having high rates of money velocity and declining interest rates. Is that possible?

Mr. VOLCKER. Again, you have to look at this in the context of shifting definitions of money and shifting technology. Ordinarily, if you didn't have any changes in the financial system, you would expect high velocity to be associated with high interest rates.

Mr. DOWNEY. So, in other words, economic recovery is predicated on something that historically is without precedent, skating on thin ice. It may hold up, but it is not something that would be a solid basis for predicting the size of deficits and the size of interest rates in the future. Would you make such a prediction, Mr. Volcker?

Mr. VOLCKER. I certainly would not predict it on those grounds alone, but there are many other influences that come to bear on this.

Mr. DOWNEY. Before the Budget Committee last week Congressman Kemp held up a chart—I believe it was weekly or monthly—of the various rates of money supply. He indicated, and it appears that more and more supplysiders agree, that the volatility of money supply is directly responsible for high interest rates. Would you comment on that?

Mr. VOLCKER. I do not believe that. I do not know quite where to begin to comment.

There is volatility in the money supply in the short run; there certainly is on a week-to-week basis. Our own, quite careful econometric analysis suggests that you could get a fluctuation of plus or minus $3 billion in the weekly figure that is statistical "noise." You get fluctuations over a period of a month or a quarter that are very sizeable.

We have no evidence that those kinds of fluctuations have any kind of important influence on economic activity or the course of the financial markets generally.

In the short run you get responses in the market to fluctuations in the money supply through a fairly simple mechanism. If the market assumes correctly that we want to maintain money on some trend course over a period of time, and then it moves either above or below that trend, the consequence may be a tightening or easing of bank reserve positions in accordance with our operating procedure, which will have some short-term influence on money market interest rates.

There is a relationship between those fluctuations and interest rates, but the issue is whether that has a real influence on the course of economic activity over time or over the general average level of interest rates, and I think that is, at the least, very hard to demonstrate.

Chairman ROSTENKOWSKI. Mr. Stark will inquire.

Mr. STARK. Thank you, Mr. Chairman.

Mr. Chairman, welcome. I would like to talk a minute about a topic you and I have corresponded on over the past couple of months, and that is the all-savers certificates. In the context of attempting to do something both for the housing market and, I suppose, the best thing there would be to provide some kind of long-range financing at whatever rate, and perhaps bring some liquidity to the thrifts who are in trouble, would you say that in the fulfiling of those objectives that the all-savers certificates, given the fact

that we estimate that it is going to cost the Government $4 billion, are probably not a very efficient way of spending $4 billion?

Mr. VOLCKER. Yes. I would agree with that.

Mr. STARK. We are going to get some pressure, I think, to renew that. We always do, when you create a loophole or a tax deduction for a short period of time. Some of us are toying with the idea of perhaps, let's say, using that $4 billion, if you will, and redirect it, perhaps in a way to provide liquidity for the thrift institutions who, if they could get some temporary interest subsidies, might be able to survive as ongoing institutions.

Would that seem to you to be a more useful way to direct the Federal resources?

Mr. VOLCKER. First, let me say the growth in all savers certificates has been much more modest, I think, than most expectations. Therefore, that revenue loss may be less than what was estimated at the time. In general I agree with your comment that if you are going to forego that revenue there must be more efficient ways of doing so.

Mr. STARK. Thank you. Let me just, for my own curiosity, it seems to me that in the money supply issue you mentioned the money market funds. I am curious about why the large brokerage houses do debit card or checking account against, say, a 50-percent line of credit against all your securities is not another form of walking around money just like an old American Express card with a line of credit.

As those things are outside your direct ability to control, as you can, say, with reserve requirements, can you keep track of them as accurately as you can bank deposits, or does that begin to make the M_1, M_2, M_3 a little bit less accurate than we have known it historically?

Mr. VOLCKER. I think the answer to that is yes, we have to make some judgment in deciding what an appropriate level of M_1 or M_2, is based upon what we judge is going on in those areas. Particularly when you get to the judgment of how that impacts on M_1, what you would really like to know is the extent to which money market funds are used as a direct substitute for money for transaction balances.

There isn't any statistic that shows you that. You can approach it by indirection and we do, but there isn't any statutes because those accounts are not neatly segregated in a way that one portion puts its hand up and says, "I am a transactions balance," and the other says "I am a savings account."

We can make indirect estimates. Last year, for instance—and this is perhaps a sign of the degree of estimating that is involved—that the growth of money market funds and their use as transactions balances probably substituted for a little over 1 percent to about 3 percent for growth in M_1. That is, I think, an appropriate order of magnitude for 1981.

Mr. STARK. Let me go on to long and short-term interest rates and availability. I get some feeling that we are talking about interest rates and we tend to think about prime and short-term money market rates that get more attention. But I begin to wonder if investors, insurance companies, banks, thrifts are going to get en-

couraged to make long-term commitments which, in my opinion, particularly for housing, is why we are on dead center.

In England we find the thrifts owning housing and people having a life tenancy sort of thing in a whole different structure. It is a correct assumption that while deficits cause an increase in rates, probably because of competition in the market, that getting people, regardless of where the rate is, to invest long is more a function of stability and confidence.

In other words, if the rate is 15, people will still stay short unless they have some confidence that that rate will go on, either that you will support the long-term bond market as, when I grew up, was what the Fed did for years, or that the country has a stable economic climate. Is that a fair assumption that we have to do something beyond just the deficit to get people back into becoming long-term investors?

Mr. VOLCKER. Yes. I think that is fundamentally correct and that is where the emphasis should be beyond the deficit, as you suggest.

I think the most important factor there is the stability of money itself, the stability of prices. Uncertainty about which way inflation is going to go—whether bonds at current rates are going to be a good buy 5 years from now—is a critical factor in the stability and level of long-term interest rates.

Mr. STARK. A final question. Is there any validity or any possibility that the government—the Federal Government—would begin to go to floating rate long-term obligations or indexed debt obligations, and is that a concept worth considering, in your opinion?

Mr. VOLCKER. It is a concept that has arisen from time to time in disturbed markets of the kind that we have. There was discussion of that, I remember, way back in the 1950's when people were disturbed at interest rates being 5 percent or so, and there was some uncertainty in the market. That discussion has been renewed to some extent recently.

I, myself, would be very reluctant to go in that direction. I think, that would be a signal to the market of giving up, that even the U.S. Government isn't willing to stake itself on a long-term fixed rate offering. That sends out a signal that one is going to live with this instability rather than deal with the instability, in my opinion.

My concern through the years has been to resist that kind of proposal.

Mr. STARK. Thank you very much.

Chairman ROSTENKOWSKI. Mr. Gradison will inquire.

Mr. GRADISON. Thank you, Mr. Chairman.

Mr. Chairman, there is more and more talk about the possibility of rolling back the tax cuts for individuals which were enacted last year. In your statement you put pretty heavy emphasis on the importance in the long run, at least, of reducing the marginal rates as far as their beneficial effect on the economy is concerned.

It seems to me that we may be at a point in the discussion of this issue that some focus has to be put on the fact that there are other kinds of taxes beyond income taxes and that one alternative to rolling back the income tax cuts would be a rather broad program of excise tax increases, such as liquor and tobacco and gasoline, and possibly some others as well.

Now without necessarily getting into the specifics of that, would you comment in general on the economic effects that you think would be significant if such a policy decision were made?

Mr. VOLCKER. I would just make two points without getting into the details, Mr. Gradison. First, as I indicated to Mr. Duncan earlier, I think a case can be made that we have, historically, relied too much on income taxes and too little on some other kinds of consumption-directed taxes; that is a general consideration along those lines.

Second, all taxes are difficult and undesirable in one sense, but you look at them in terms of the variety of objectives that you have. You mentioned the gasoline tax. You could broaden that into a tax directed at energy where the price impact is undesirable in terms of effect on the consumer price index, but where there are some desirable implications in terms of conservation of energy. Indeed, certain types of energy taxes—say an oil import fee—can help incentives to explore for oil domestically as well as dampen demand for energy.

There are those kinds of considerations that can be looked at, too, in terms of the overall need to produce more revenues.

Mr. GRADISON. I have one other question I would like to pursue. You used the term, I believe, "crowding out" and we are hearing a lot about it. Yesterday we heard a term that was new to me from the Secretary of the Treasury—"crowding in"—which I think was his suggestion that the increased savings rates which the administration anticipates from the mix of policies of the administration will make it possible to finance the deficit and finance our industrial needs as well.

I wonder if you could quantify for us, at least in a rough way, the extent to which crowding out is likely to take place in the near future. I realize in the longer term there is hope that we will have much higher savings rates and be in a better position to finance whatever Federal deficit we have as well as private needs. But in the shorter run what do your figures show in terms of the impact of Federal borrowing, on-budget and off-budget, measured against the pool of available funds?

Mr. VOLCKER. There are a lot of different ways of looking at this. As you know, Mr. Gradison, if you take a direct financial market look—not looking at savings directly but looking at what the Federal Government takes in borrowing in the market—you find the typical pattern; the Government's share goes way up in recessions when private credit demands decline and Government goes up.

But if you look at the figures for the last decade or more you will also see a rising trend in that relationship where the Government, over time, has taken more and more. And if you project out the current services deficit to figures of $150, $160, $170 billion you would find the Federal Government taking a bigger share of the credit markets in a period of projected recovery and expansion that exceed what was typical in past recessions. You get up to a Government share of 30, 35 percent or so.

Mr. GRADISON. Thirty, thirty-five percent during the recovery stage?

Mr. VOLCKER. Yes. With no action on the deficit, that's right.

If you got the deficit down to the under-$100 billion area, you would still be left, for a recovery period, with a relatively high Government share, estimating as best one can. It will not be as high as it has been in some recession periods, but it will be exceptionally high for a period of recovery, which raises questions, indeed, of whether the recovery could even proceed with the Government taking that big a share.

You get a similar picture—the numbers are somewhat different—if you look at the Government as absorbing a portion of national savings. Again, it depends upon whether you look at gross or net savings. You get very dramatic figures if you look at net savings; if you took that current services budget and set it against any reasonable projection of net savings, you would find a very large proportion of the net savings is offset by the Government deficit.

If you include capital consumption allowances in the savings figure, you get a smaller proportion, but it would still be high historically. You would, in effect, go to another plateau.

All these calculations depend upon particular judgments about what the savings rate will be; when I make these judgments, I assume a rise in the savings rate, but a rise that seems reasonable to me.

Mr. GRADISON. Could you supply for the record the data which you are looking at?

Mr. VOLCKER. I can certainly supply the historical data, and I can supply some hypothetical estimates. It is very difficult to make these estimates, and I wouldn't put a lot of weight on any particular estimate, but I think when you look at these numbers you can see where the risks lie. I think that is all you can say, except that this weight would become very heavy.

[Chairman Volcker subsequently submitted the following information for the record:]

Table 1 shows an estimate by Federal Reserve staff of total credit obtained by nonfinancial sectors of the economy that might, in terms of historical patterns, be consistent with the Administration's GNP forecast for fiscal year 1982–84. As may be seen, absent the enactment of the Administration's deficit reduction program, the Treasury will be absorbing a very large share of aggregate credit flows (and these figures on Federal borrowing do not include guarantees or sponsored agency takings).

These data employ Administration estimates of the deficit. The CBO has estimated significantly higher deficits, before or after assuming enactment of the President's budget.

Note also the appropriate historical comparisons for fiscal 1984 should be with earlier prosperous business years, not with recession year when Federal financing is normally an exceptionally large share of credit markets.

Table 2 give some hypothetical saving projections, based on patterns observed in earlier years. While the range of possible outcomes is substantial, the figures indicate that the federal deficit will be absorbing a comparatively large share of total private saving in the economy unless major steps are taken to cut spending or increase revenues. It is interesting to note that the deficit-to-saving ratio looks especially high in comparison to earlier experience in relatively prosperous times, which is the appropriate comparison for projections based on an assumption of a high level of business activity.

Note that these data are Administration deficit, program and GNP estimates; other estimates (e.g., by the CBO) suggest higher deficits and consequently greater strain on our savings capacity.

Table 1

FEDERAL BORROWING AND CREDIT MARKETS

Fiscal years	Total funds raised by nonfinancial sectors[1]	Federal borrowing from the public	Federal borrowing as a % of funds raised
	($ bil)	($ bil)	(%)
1972	152	19	12.8
1973	198	19	9.8
1974	187	3	1.6
1975	174	51	29.2
1976	242	83	34.3
1977	310	54	17.2
1978	379	59	15.6
1979	413	34	8.1
1980	342	70	20.6
1981	405	79	19.6
1982e	420	115 (118)[2]	27.4 (28.1)[2]
1983e	494	108 (164)	21.9 (33.2)
1984e	548	97 (181)	17.7 (33.0)

1 Nonfinancial sectors, excluding equities.

2 Numbers in parentheses assume the Administration's deficit reduction program is not enacted.

Source: Special Analysis F, Budget of the United States Government, 1983 except for 1982, 1983, and 1984, which are staff projections based on Administration's economic and budget projections.

Table 2

DEFICITS, GNP AND SAVING

Fiscal Years	Budget Deficit ($ billions)[1]	Deficit as % of GNP	Deficit as % of gross non-federal saving[2]	Deficit as % of net non-federal saving[2]
*1965	-1.6	0.2	1.5	3.0
1966	-3.8	0.5	3.2	6.1
1967	-8.7	1.1	6.7	12.9
1968	-25.2	3.0	17.7	34.5
1969	3.2	0.4	2.3	5.0
*1970	-2.8	0.3	1.9	4.2
1971	-23.0	2.2	13.5	29.3
1972	-23.4	2.1	11.9	24.9
*1973	-14.8	1.2	6.6	13.1
*1974	-4.7 (-6.1)	0.3 (0.4)	2.0 (2.6)	4.2 (5.5)
1975	-45.2 (-53.2)	3.1 (3.6)	18.2 (21.5)	45.8 (53.9)
1986	-66.4 (-73.7)	4.0 (4.5)	22.8 (25.2)	53.2 (59.0)
1977	-44.9 (-53.6)	2.4 (2.9)	13.0 (15.6)	29.1 (34.7)
*1978	-48.8 (-59.1)	2.3 (2.8)	12.3 (15.0)	27.0 (32.6)
*1979	-27.7 (-40.1)	1.2 (1.7)	6.6 (9.5)	15.9 (23.0)
1980	-59.6 (-73.8)	2.3 (2.9)	13.3 (16.5)	35.2 (43.6)
1981	-57.9 (-78.9)	2.0 (2.8)	11.7 (15.9)	31.5 (42.9)
Potential Deficits with No Saving Plan (Administration's "Baseline")[3]				
1983	-147 (n.a.)	4.3 (n.a.)	21.2 (n.a.)	n.a.
1984	-167 (n.a.)	4.4 (n.a.)	20.7 (n.a.)	n.a.
Administration's Proposed Deficits				
1983	-92 (-107)	2.7 (3.1)	13.2 (15.4)	n.a.
1984	-83 (-97)	2.2 (2.6)	10.3 (12.0)	n.a.

	Deficit adjusted to 6% unemployment	High Employment Deficit as % of potential GNP	High Employment Deficit as % of gross nonfederal saving[4]	High Employment Deficit as % of net nonfederal saving
Potential Deficits with No Savings Plan (Administration's "Baseline")[3]				
1983	90	2.5	13.7	37.0
1984	128	3.2	18.0	48.6
Proposed Deficits				
1983	35	1.0	5.3	14.4
1984	44	1.1	6.2	16.7

1. Unified budget deficits; data in parentheses include "off-budget" programs financed by U.S. government.
2. NIPA gross saving excluding NIPA Federal surplus (or deficit) plus net foreign investment (sign reversed); net nonfederal saving equals gross less capital consumption allowance with adjustment.
3. CBO estimates of baseline deficit are somewhat higher.
4. Saving as percent of potential GNP equals ratio in average of high employment years in the 1970s.

*Reasonably prosperous years; unemployment rates of 4.9%, 4.0%, 5.2%, 5.0%, 6.3%, and 5.8%, respectively.

Mr. GRADISON. One final very short question. Mr. Chairman, there is concern in the credit markets about the size of the deficits. They are projected on the order of $100 billion and $150 billion, depending on whose figures you use. How much do you feel we would have to bring that down for fiscal 1983 to be sending a clear signal to the credit markets that we were really taking a meaningful step toward bringing the deficit under better control?

Mr. VOLCKER. I would think your first benchmark in that respect is the order of magnitude that the administration has proposed. If you do less than that, which I think the market fears to a considerable extent, you are clearly not sending a favorable signal. I am not sure how strong the signal from such action would be in a favorable sense; I would prefer that you went beyond that, as I indicated. Then I think you would have a strong signal.

Mr. GRADISON. How much further, on an order of magnitude?

Mr. VOLCKER. I said 6 months ago, Mr. Gradison, that in terms of the 1984 problem—and that is kind of my benchmark year—you will have had plenty of time for the economy to expand, and so you are looking at an economy that will be performing, by assumption, anyway, at a good level. You are looking at a $100 billion budget problem. The administration has proposed, depending upon how you look at it, an $82 billion or $84 billion deficit, but since then, the budget problem has gotten bigger, if anything, so as an order of magnitude, I am suggesting another $20 billion or so.

Mr. GRADISON. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Heftel will inquire.

Mr. HEFTEL. Thank you, Mr. Chairman.

Welcome, Mr. Volcker. Mr. Volcker, to the extent that productivity or the lack of it may be a basic problem underlying our economic ills, do you think we should at least be discussing some form of a tax-based incomes policy in trying to address that problem?

Mr. VOLCKER. I am not sure a tax-based incomes policy would go to the productivity problem, but it goes to another very important problem, and the momentum of costs and wage increases.

Mr. HEFTEL. Do you think we should at least be discussing alternatives such as a policy that would utilize the tax system to reward profit-sharing productivity contracts between management and labor, and that would build into the tax code a reward and punishment system that would be based upon how productive you are, assuming adequate data is available to construct such a system?

Mr. VOLCKER. Discussing it, yes. I have not seen a proposal that I think is practical. I think it attempts to deal with a major problem. I cannot honestly say I think it is a promising approach now because it is so complicated and so inevitably arbitrary in practice and so difficult to administer. All these plans lead to some distortions because you have to generalize about what is an appropriate increase, and who gets the reward and who doesn't.

It is much more attractive in concept—to talk about for 5 minutes or 15 minutes—than against the problems that exist in practice, and that is where I think it founders.

Mr. HEFTEL. I think that is the reason, of course, that we are not discussing it. It is complex. It is difficult.

Second, would you agree that our first order of business should be to go back to the drawing board and the balanced budget con-

cept; that there is probably no more important contribution we can make to solving the economic problems than a balanced Federal budget?

Mr. VOLCKER. When you say balanced budget, clearly we are not going to have a balanced budget this year or next year or the following year.

Mr. HEFTEL. But we have almost given up talking about the balanced budget. We are so far from it now we are afraid to talk about it.

Mr. VOLCKER. That is right, and I think we all might lose sight of it. We must not lose sight of the importance of the concept. I don't have any better concept, although it is an imperfect one, to propose to you than that you keep very much in mind the importance and the discipline of restoring a balanced budget at high levels of economic activity.

I wouldn't make those levels of economic activity so high they are impossible. If we could balance the budget or set in motion a program that has a reasonable chance of balancing the budget at, let's say, something like 6 percent unemployment—which is roughly as low as we have been in recent years—and run a surplus if the economy were running at a higher level than that, I think that would give you an appropriate benchmark.

Again, that is an order of magnitude in an imperfect world, but I think that is the kind of benchmark you ought to be thinking about. If you have an economy operating at that level, there are going to be all kinds of demands and pressures for home building, for business investment, for inventory, and all the rest. All that has to be financed. The Government ought to get out of the way in terms of its deficit.

That concept is embedded in a balanced budget at a high level of economic activity.

Mr. HEFTEL. Would you go so far as to trying to build into the legislative process even a constitutional amendment that mandates under certain conditions a balanced budget?

Mr. VOLCKER. To the extent you can build that into the legislative process, I would certainly support that. How do you build that kind of statistical concept into a constitutional amendment? To the extent the legislative process can be biased in that direction, so to speak, I think that would be very healthy.

Mr. HEFTEL. Thank you.

Chairman ROSTENKOWSKI. Mr. Guarini will inquire.

Mr. GUARINI. Thank you, Mr. Chairman.

Mr. Volcker, if you have seen today's Wall Street Journal, the lead article says that many analysts say that the "Fed Fails in Money Control." It says that in October 1979 there was a policy that the Federal Reserve would be paying less attention to interest rates and more attention to money supply. It asks the question whether or not monetarism is dead and quotes Allen Melser of Carnegie Mellon Institute, who says that in October of 1979 there appeared to be an abandonment of the experiment and that we are spending too much time and too much effort concerning ourselves with the interest rates and not enough concern with money supply.

Could you comment on that article?

Mr. VOLCKER. I don't agree with it. I don't know how I can comment beyond that. We certainly have a lot of fluctuations in interest rates, but I think the pattern over that period since 1979 is quite clearly one of success in bringing down the trend in money supply growth. We have had a lot of fluctuations on a monthly or quarterly basis, that is certain; but I think if you look through those you see a trend of decline in the money supply in M1 over the past 3 years of a little more than 1 percent a year.

Mr. GUARINI. You don't think that interest rates get too much attention by the Federal Reserve today?

Mr. VOLCKER. No.

Mr. GUARINI. Is there a perversity in the fact that when there appears to be an increase in the money supply, the interest rates have been going down where they should be going the other way?

Mr. VOLCKER. A perversity that arises largely for the reason I suggested earlier, perhaps before you came in. If the money supply is rising above trend, so to speak, above the objectives, and that persists for any period of time, pressures will arise on the banking system.

Mr. GUARINI. Is that because Wall Street may be guessing that the Federal Reserve is going to lower the interest rates and therefore for political reasons the perversity continues?

Mr. VOLCKER. I think it rises largely because the anticipation is that a persistent rise in the money supply will be resisted, and it is in fact resisted; and both the expectation and the reality, in the short run, bring higher interest rates in the money market. In the long run, it may have a different effect.

Mr. GUARINI. Have you been surprised as to the way the interest rates are reacting in view of the money supply that is available?

Mr. VOLCKER. I am often surprised, but I am not broadly surprised by the relationship that I just described. There was certainly an element of surprise in the rise in the money supply late last year and early this year, but given the rise in the money supply, given that that was reflected rather promptly in increased pressures on reserve positions, some increase in interest rates was not surprising.

Mr. GUARINI. As an economist and a person who has held various positions, Assistant Secretary of the Treasury and Federal Reserve Chairman, banker, you have a unique perspective from which to look at the economy. Are you familiar, and I am sure you are, with the baseline economic assumptions of the administration, and if so, do you agree with them and do you use them in your computations when you look at fiscal policy?

Mr. VOLCKER. In looking at fiscal policy, I think that those are reasonable assumptions to make. You have to have some kind of a baseline.

Mr. GUARINI. We are talking about fiscal year 1983: unemployment, 7.9; interest rate on TD's, 10.5; real gross national product, 5.2; consumer price index or inflation, 6 percent. Do you agree from your perspective and as an economist with those assumptions that are made by the administration?

Mr. VOLCKER. Let me make a distinction between an assumption and a forecast. They have to make some assumptions, anybody does, in projecting some budgetary figures. I think it is entirely

reasonable in terms of the growth numbers to make an assumption over a series of years, beginning where we are now, of an economic expansion; you can argue where the decimal point should be and all the rest, but not with the assumption of an economic expansion that is not exceptionally large by past postrecession.

Mr. GUARINI. But it does have an effect on our deficit.

Mr. VOLCKER. That is right.

Mr. GUARINI. Do you use those same assumptions in your monetary calculations when you decide monetary policy?

Mr. VOLCKER. No, but we don't make a forecast out in that distance.

Mr. GUARINI. In other words, the administration works in one direction with one set of assumptions when they do fiscal policy, and the Federal Reserve does another set of assumptions when they do monetary policy?

Mr. VOLCKER. Not necessarily different. We don't feel the necessity for making an assumption out 2 or 3 years into the future.

Mr. GUARINI. I know, but you need a benchmark for fiscal year 1983, and when you decide monetary policy, unless you begin somewhere from some baseline, shouldn't it be in tandem with the administration so that we are all speaking the same language?

Mr. VOLCKER. We certainly look at 1982. We have a year ahead of us for that now.

Mr. GUARINI. But we are talking about the 1983 budget. That is what we are addressing ourselves to now. I am just wondering whether or not the administration and the Federal Reserve are speaking the same language or whether there is no communication because there is a different set of assumptions that you are individually working from when you decide fiscal policy and, on the other hand, monetary policy.

Mr. VOLCKER. I do not think that is a real problem. We take the figures as assumptions. They are useful assumptions in analyzing the budgetary picture. The point is that obviously, if the economy turns out to be weaker than that, all things equal, the deficit will be larger, but it would have a different significance in those circumstances. Similarly, if the economy turned out to be stronger, the deficit would be lower.

Mr. GUARINI. I wonder if we are all pulling in the same direction. That is what I am worried about. There has to be something, obviously, wrong with our economy, and if we are not really relating to each other, obviously we would be working counterproductively.

Mr. VOLCKER. I do not think that is a source of difficulty. I look at an assumption for budgetary planning purposes. I do not think this causes any difficulty. Now, forecasts are somewhat different, but we don't really attempt to make a realistic judgment beyond a span of 12 months or so.

Mr. GUARINI. Thank you.

Chairman ROSTENKOWSKI. Mr. Moore will inquire.

Mr. MOORE. Thank you, Mr. Chairman.

Mr. Chairman, many people have commented and blamed the high interest rates solely on actions of the Federal Reserve System, ignoring Federal deficits, ignoring people in the marketplace, feeling that maybe inflation is not under control and keeping the high

interest rates up for that reason, a shortage of capital, for whatever the other reasons may be. They seem to ignore these and blame the Federal Reserve System exclusively for the high interest rates.

I would ask you to comment on that, and also in your comment give me an idea, if you could, what the interest rates would be or how much they would drop tomorrow or in the next week if suddenly the Federal Reserve System abandoned completely its tight money policy.

Mr. VOLCKER. I suspect that if the Federal Reserve really abandoned restraint on growth of money and credit, it would not take long for interest rates to be much higher than they are now, which is precisely the kind of problem that we are in. The market is preoccupied with concerns about inflation, as you suggested. They are concerned about the deficit outlook.

Just taking the inflation point, if they felt that all restraint was off inflation in the future, that we abandoned this great effort to turn around the inflationary momentum, that we were giving up, and were going to permit inflation to continue, I can assure you that financial markets rather rapidly would respond and long-term interest rates in particular would be higher, because nobody is interested in buying a long-term bond under those circumstances.

I would like to think and I do believe, Mr. Moore, that our policy is the only real promise of getting the interest rates down over a period of time and keeping them low. We have to deal with that inflationary environment.

Mr. MOORE. You touched on in your statement that one way for us to conquer inflation and bring down interest rates is to increase the real savings rate of individuals, which we set some incentives in motion in the 1980-81 tax bill, believing that enlarging the capital pool by increasing individual savings will help make more money available and thereby reduce its demand and reduce interest rates. We are hoping these things are in motion.

I recently had a prominent banker from New York City, however, express the fear to me in private, and I ask you to comment on this, that even if we do see an increase in real savings, even if we do see more money being deposited by individuals, increasing the capital pool, in his words he is afraid the Federal Reserve System will simply sop that money up by calling it an increase in money growth, an increase in the money supply, therefore requiring even more stringent monetary controls, prohibiting any real benefit coming from that increase in money supply by virtue of savings.

To me, I see a difference, and I would like to hear your comment on this, between an inflationary money supply and a real increase in money supply coming out of consumption and going into savings by virtue of savings rates. Is that fear by that banker realistic?

Mr. VOLCKER. No; I don't think so. We look at various monetary aggregates. If you look at the narrow aggregate, M_1, you would not think, historically at least, that that would capture much, if any, of an increase in real savings. Historically, no interest was paid on those balances. If someone were going to save some more, they would not put money into a checking account.

The situation does get a little bit more difficult to interpret to the extent that funds we count as money in that narrow sense do

have some savings element. I would not think that is particularly important at the moment because, although we do now permit a payment of interest on NOW accounts, it is at a relatively low level, so you wouldn't think that people would ordinarily accumulate savings in that form. If they did so, we would then have to allow for that.

Recently there has been an exceptional increase in NOW accounts. Practically all the increase in the money supply recently has been in NOW accounts, and it seems to reflect some shift, probably temporary, in liquidity preferences of individuals. They really want to put their money where they can get at it in a hurry. Savings accounts have also been going up. Both have low interest rates. But I would expect that to be a short-lived phenomenon, not a kind of permanent repository for savings. If it were, we would have to allow for it in monetary targets.

Mr. MOORE. You say allow for it in the monetary target. Then you are telling me that if we can see and measure a real increase in permanent savings, that will not result in the Fed tightening up further its controls.

Mr. VOLCKER. Some members of the Federal Open Market Committee have this concern with respect to M_2, a much broader aggregate, which does include a very large amount of individual savings. We discussed that very point and agreed that we would assess it as time went by and would have to reassess the target if necessary—at least where we came out in the target—if there was real evidence of an increase in savings going into that form.

I don't expect that to happen, but it is theoretically possible.

Mr. MOORE. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Russo will inquire.

Mr. RUSSO. Thank you.

Mr. Chairman, yesterday the T bill auction indicated a drop of about 2 percent in the 2- and 6-month T bill rate. Some people have indicated that that has been the biggest drop in its history. Is this a significant breakthrough in the reduction of interest rates?

In addition to that, last Friday there was a $3 billion drop in the money supply. Do you think the two in combination would finally give the financial community the confidence in the policies that you were espousing at the Fed?

Mr. VOLCKER. I would not overinterpret any one week's move either in the interest rates or the money supply; that is a good way to get fooled by the next week's developments.

What we had recently was a sharp increase in the money supply, early in January, and we have had some pretty sharp increases in interest rates from the lower level they reached at the end of last year to the level in January and early February. Those movements have reversed themselves recently, but we will watch and see what the future brings; where there is a rather sharp increase——

Mr. RUSSO. That is not a strong indication that in the future interest rates will be coming down?

Mr. VOLCKER. I would hope that they are; interest rates are very high. But I am not going to predict that on the basis of one week's figures.

Mr. RUSSO. Let me ask you another question, Mr. Volcker. As I understand it, in the fall of 1979 the Federal Reserve Board had

changed its basic monetary policy from attempting to control interest rates to attempting to control the money supply. Is that an accurate summary of the change of policy? And second, based on the experiences since 1979, are you still convinced that that change in policy was wise?

Mr. VOLCKER. What we did in October of 1979 was to put much more emphasis, all our emphasis virtually, on controlling reserves in relation to the money supply target. We had a money supply target before, but we used a different technique to try to achieve it.

We expected one result would be more instability in interest rates; we certainly had that. Under the particular circumstances in which we have been operating, I am relatively satisfied that that was a useful change. It certainly is going to be continued, and it has been reflected in a trend in money growth pretty much in line with our objectives.

Mr. RUSSO. Mr. Volcker, last week we had testimony from Paul Craig Roberts who indicated that the source of panic is the massive uncertainty about monetary and fiscal policy. He says that the administration's projections last year were based on the assumption that the Federal Reserve Board would produce a moderate or predictable on-target growth in the money supply.

He further said that the Fed was never within its target range. In the early spring the Fed was above target, and then from April to October the Fed was below target, allowing the amount of money in the economy to actually fall by $300 million, helping to bring on a recession.

He further stated that now the Fed has again moved above its target, contradicting in words its actions—by creating the impression that the Government is going to fight the economy out of the recession.

Volatility in monetary policy makes it difficult for market participants to know or guess what the monetary policy is or what direction it is going. It adds an uncertainty premium to interest rates. The greater the uncertainty, the greater the premium.

It is beside the point for the Fed to say that the U.S. monetary policy is less volatile than some other countries. The relevant point is that U.S. monetary policy is more volatile than before, so for U.S. financial markets there is a rise in uncertainty.

Would you comment on that statement?

Mr. VOLCKER. Obviously I do not agree with it. I suggest that in terms of the credibility and predictability of monetary policy, you might get testimony from people in the marketplace as to whether they would agree with that or not.

I think what that statement overlooks is that there is a demand for money as well as a supply of money. We can influence the supply. In the short run, fluctuations in the reported money figure tend to reflect shifts in demand, and demand for money in the narrow tolerance in which we measure it can be rather volatile.

I think that is the relevance of foreign experience; money demand is volatile all over the world, and you cannot be successful in keeping it on a perfectly rigid path from week to week or month to month or even quarter to quarter.

Mr. RUSSO. What about the problems of not staying within your target range, above and below, creating uncertainties?

Mr. VOLCKER. I do not know what target range he is referring to. In M_1 we were never above the target range last year, never, so I do not know what he is referring to. We ended up below it, and we were below it a considerable part of the time.

M_2 was hovering around the upper part of the target range during most of the year.

Mr. RUSSO. He is referring to M_1.

Mr. VOLCKER. I am sorry, but he is using the wrong figure. He is using M_1 unadjusted; that's not our target.

Mr. RUSSO. If you have tight monetary policy and expansionary fiscal policy, would you say that is consistent policy?

Mr. VOLCKER. I think you would be better off if you had a tighter fiscal policy.

Mr. RUSSO. How would you characterize the Reagan fiscal policy? Would you say it was tight, restrictive, expansive?

Mr. VOLCKER. His proposals are obviously an effort to tighten it from what it would otherwise be.

Mr. RUSSO. Would a $100 billion deficit indicate an expansionary fiscal policy, a $750 billion tax cut over 5-years, and a $1.6 trillion spending in defense? Would that be expansionary, restrictive, or in line with your tight monetary policy?

Mr. VOLCKER. I expressed my feeling that I would urge you to do at least as much as he has proposed. To tighten fiscal policy I would urge you to go beyond that.

Mr. RUSSO. Thank you.

Chairman ROSTENKOWSKI. Mr. Matsui will inquire.

Mr. MATSUI. Thank you, Mr. Chairman.

Chairman Volcker, let me make a couple of assumptions, if I may. Let us assume that the deficit for the fiscal year 1982 hits $100 billion, and the deficit for the fiscal year 1983 hits in the neighborhood of $110 and $120 billion, and let us say that we cannot pass the budget, but we have a series of continuing resolutions and a shortfall between $110 and $120 billion.

What is your forecast in terms of what occurs in 1982 in terms of the interest rates and whether there is any positive 3-month period of GNP during 1982?

Mr. VOLCKER. I do not know what assumption you are making as to the level of business activity when you cite these deficit figures. Any deficit number can have different significance depending upon what the economy is doing. If you took the assumption of the administration of roughly 5-percent growth during this period and you had deficits that large, you would have, in all probability, an historically large drain on savings in financial markets from the Federal deficit; interest rates would be certainly higher than they otherwise would be; and you would call into question, among other things, the reality of the assumption you make about the business outlook.

Mr. MATSUI. In other words, you would abort the recovery undoubtedly?

Mr. VOLCKER. You would certainly risk that, yes.

Mr. MATSUI. And if we talked about no expansion because of the current high interest rates, we continue with the recession; so basically, whatever assumption we take will indicate a reasonably bad year in terms of 1983.

Mr. VOLCKER. I think the only safe course is to urgently reduce the deficit; that is urgent.

Mr. MATSUI. But you do not necessarily agree with Secretary Regan's comment which he made yesterday that he expects recovery in the spring of this year if we adopt the President's budget with the $91 billion deficit figure?

Mr. VOLCKER. No; I think it is probable that we will have recovery beginning in the spring, by midyear, around that time.

Mr. MATSUI. What was that?

Mr. VOLCKER. I do think that as a probable course of events we will have some recovery in the latter part of the year.

Mr. MATSUI. But would your other scenario come into play if we have a high deficit?

Mr. VOLCKER. I think you best assure recovery happening and you best assure it continuing by forceful action to deal with the deficit. That is the whole point of my testimony this morning. The more action you take to deal with that deficit, the better assurance you are providing not only that the recovery will begin but, as you properly point out, that it will be sustained. That is the very simple point I make this morning.

Mr. MATSUI. Secretary Regan in January said that he wanted to see a growth rate for the money supply in the 1982 calendar year of about 6 percent. You're looking at 4 to 4½ percent. If we go to 6, what difference does that make, or does it make any difference?

Mr. VOLCKER. I do not recall him ever saying anything like 6.

Mr. MATSUI. He said 7 for 1981 and 6 for 1982.

Mr. VOLCKER. That is beside the point. We think our targets are appropriate, obviously. We did say that we would target 2½ to 5½ percent. The proviso is partly a question about what money market funds in particular will be doing this year and whether the so-called sweeping arrangements will arise in big volume and what DIDC will do with respect to a deposit instrument that might attract money out of M_1. Leaving those aside for the moment, we suggested that an increase in the upper part of the range would seem appropriate as we now see things; the middle of the range is 4 percent.

Mr. MATSUI. Thank you.

Chairman ROSTENKOWSKI. Mr. Martin will inquire.

Mr. MARTIN. Thank you, Mr. Chairman.

Mr. Volcker, this recession that we are in appeared to begin sometime around the middle of last year, around June, July of 1981. Would it be your opinion that that onset of that recession was due to the then prevailing high interest rates that were around in early 1981, or was it due to the tax cut?

Mr. VOLCKER. You cannot distinguish among all these things so easily.

Mr. MARTIN. Does a tax cut bring on a recession?

Mr. VOLCKER. Clearly, high interest rates have an immediate impact on the business situation. You have to ask yourself why were interest rates so high, what were the alternatives, and all the rest.

You had a period during the summer when short-term rates were declining. Short-term rates declined through October, through early December; they reached their peak in June or July and de-

clined kind of erratically for some months while long-term rates were rising. Long-term rates, as I recall, reached their peak as late as September, October.

Mr. MARTIN. Would it not more likely result from the interest rates that were high earlier in the year? Does that not have an effect?

Mr. VOLCKER. Certainly these things work with a lag, and the interest rates were high early in the year.

Mr. MARTIN. Generally speaking, during a recession would it be your expectation that a tax increase will help to speed up and strengthen the recovery?

Mr. VOLCKER. You ordinarily would not expect that in the middle of a recession, no; I am not talking about any budgetary action now.

Mr. MARTIN. Tax increase?

Mr. VOLCKER. I am not talking about a tax increase effective during this recessionary period. My focus is more out on 1983 and more particularly 1984. That affects today's markets because markets look ahead. That is the focus, not the deficit in 1982, which is indeed heavily affected by the recession. If you assume the recession away and you assume the high level of employment in 1982, you would not have much of a deficit; but if you made that same assumption for 1984, you would have a very big deficit.

Mr. MARTIN. Now, as to the type of tax increase in late 1983 and 1984 that would have the least effect, that is, the least weakening effect on the recovery, I believe in your discussion with Mr. Gradison you indicated that you would favor taxes on consumption rather than on investment and risk taking and marginal tax rates. Am I correct?

Mr. VOLCKER. I certainly think that should be examined, and that reflects the direction in which the tax system should go in general, yes.

Mr. MARTIN. That is your own philosophy and view on it. A lot of people speak of a tax cut, and often they try to characterize it as though it really is a tax cut. Do you agree with me that after the biggest tax cut in history enacted last year that taxes really are not going down, that the increase in taxes was just cut in half?

Mr. VOLCKER. I do not have the data right in front of me, but my impression is that taxes are going down, partly offset by the bracket creep and the inflationary effect.

Mr. MARTIN. And social security taxes. Both OMB and CBO and other wizards show that revenues are projected to rise about as fast as the rate of inflation over the next 3 or 4 years.

Now, of course no one knows for sure what is going to happen beyond yesterday, but——

Mr. VOLCKER. They may rise as fast as the rate of inflation. I do not think they are rising as fast as the rate of the nominal GNP.

Mr. MARTIN. Because if GNP grows faster than inflation, and taxes rise only as fast as the buying power of the tax dollar as eroded by inflation, then you have the net effect of no real growth or no real reduction in taxes.

Is that approximately right?

Mr. VOLCKER. If taxes just kept up with the economy——

Mr. MARTIN. Just kept up with inflation.

Mr. VOLCKER. If they just kept up with inflation, then presumably you would have some reduction if you had some economic growth. It would not be very rapid.

Mr. MARTIN. But not in relation to the buying power of those dollars.

Mr. VOLCKER. Taxes as a percent of the GNP would go down.

Mr. MARTIN. Yes. If GNP rises faster than inflation, yes, sir.

It has been estimated that at the current services level of the fiscal 1983 deficit—and by current services I mean if there is no action by Congress to do anything, if we do not pass the President's budget and do not pass anybody else's budget either—that the current services level will lead to a deficit not of $92 billion, which all of us find abhorrent, but a deficit of $150 billion. And I would wonder if since that is about $80 to $100 billion higher than anybody predicted last year whether there is some assessment of why it is so large, as to how much of that current services fiscal 83 deficit is due to the recession, how much is due to high interest rates, how much of it is due to unemployment—all of these being much worse than anyone predicted.

And I see my time is up.

Mr. VOLCKER. It depends on how far out you go. The immediate problem in 1982 and, to some degree in 1983 is certainly affected by the recession. As you assume business expansion—as the administration does and as the CBO does—you are still left with those very big deficits, and I think in large part because they were underestimated last year.

Mr. MARTIN. Would you be able to provide the committee some estimate from your office of the contribution of recession and high interest rates, unemployment, and to the extent the fact that inflation is better than anyone projected, because that will reduce revenues also because it moderates the bracket creep, so that we can see how big a factor these are. That leads us to——

Mr. VOLCKER. As compared to what?

Mr. MARTIN. As compared to projections in the previous year, a range of projections.

Mr. VOLCKER. The administration's projections in the previous year?

Mr. MARTIN. You can take the Reagan administration, the Carter administration, the OMB or any other consensus. I believe you will find that there is a range of about $40 to $60 billion deficit that was projected for fiscal 1983 last year, and now it appears that it is $150 billion. And I am trying to see how much of that——

Mr. VOLCKER. I would be glad to try to provide you with something. The difficulty is in distinguishing how much of the estimate last year was just a bad estimate.

[Chairman Volcker subsequently submitted the following information for the record:]

In March 1981, the Administration's budget projected a deficit of $22.8 billion in fiscal year 1983, assuming $28.9 billion of unspecified spending reductions that were to be proposed in the 1983 budget and implemented in that year. Therefore, in the absence of those additional spending reductions, the deficit would have been estimated to be $51.7 billion (abstracting from the "second round" interactions between alternative budget deficits and the economic forecast underlying the budget projections). In the absence of deficit reducing measures, but assuming the Administration's defense program and other minor increases in outlays, the deficit for fiscal

year 1983 is now projected by the Administration to be $147 billion. (The Congressional Budget Office "baseline" projection is for a fiscal year deficit of $157 billion.) The Administration estimates that about $89 billion of the rise in the projected deficit between last March and the present is attributable to revised economic assumptions. This total subdivided the following way:

	Billions
Effect of lower nominal income on tax receipts	$52.6
Net effect of higher unemployment but lower inflation on outlays	5.3
Effect of higher deficits and higher interest rates on interest outlays	31.1
Total	89.0

Another way of looking at the question of the effect on budget estimates of revised economic assumptions to note that the projection of unemployment in fiscal year 1983 1.3 percentage points higher than was projected a year ago would imply a deficit about $35 billion larger. In combination with higher interest outlays, about $66 billion of the upward revision in the deficit is therefore readily explainable. The remaining $29 billion of upward revision reflects the lagged effects of weaker economic conditions in 1982, technical re-estimates that reduce receipts (or add to outlays) and some short-fall from outlay saving goals set in the 1982 budget.

Mr. MARTIN. Well, take the highest estimate and go from there. It still is twice as bad as the worst estimate that anyone provided us with last year. That is significant. There must be some explanation that we can come up with, and it may show you that there is some irreducible deficit that is a consequence of the recession being so bad. That might give us something to look at.

Chairman ROSTENKOWSKI. Mr. Bailey will inquire.

Mr. BAILEY. Thank you, Mr. Chairman.

Chairman Volcker, you probably do not realize how lucky you are. I am under instructions to start easy on you, but I know I could not give you a problem anyway. I will take it easy.

I was looking over your statement and listening to some of the comments you made to other members, and particularly on page 5 you make reference to money supply increases due to the tendency of people to "place marginally more of their assets in highly liquid form."

I would deduce that that is a reflection of some type of confidence problem or confidence equation. I would assume that is what is in your thinking.

Mr. VOLCKER. Yes.

Mr. BAILEY. OK. Let me also add that I think it is politically unreasonable to assume that you are even going to get the cuts or the kind of cuts that the President wants. I just do not think politically—I may be wrong, and I am sure you hope that I am—but I do not think that is there.

I think, therefore, we must look to the revenue side or at least consider it more perhaps from my listening to your statements than you would like to.

That equation in my mind means that you have some serious concerns about reinvestment problems in the country. Naturally, with productivity difficulties the way they are, I do, too.

My primary concern has been long-term reinvestment problems, patterns in the past and in the future, and essentially I am speaking of capital intensive industries, specifically the impact on the Nation's economic and military security.

If we have a reindustrialization problem, then what would your reaction be? You commented on the personal income tax, and we

are comparing it to some of the apparent preferences that you would have for more consumption-oriented taxes. You did not express sympathies either way on the nature of that income tax except to say that apparently it is higher excessive graduation. You apparently think it acts as a disincentive. And I would assume that that also would connect with the thinking in your mind about our reindustrialization and productivity and reinvestment problems.

Now, the administration proposals are essentially $2½ billion user fees and $½ billion user fees and miscellaneous revenue enhancers, minimum corporate tax changes. I am sure you are not a refundability advocate, and you would consider that a resource distortion, I would imagine—but certainly a corporation under the laws of the land should have a right to a zero tax liability, not necessarily some enforced positive tax liability, which is also a distortion, in my opinion, because these are essentially capital intensive industries.

Now, would you comment in terms of what that word "productivity" means and extrapolate from the opinions you have expressed here about the personal income tax, how wise you would think some inhibition in taxes that would further inhibit capital reinvestment and what not would be. Surely, it would not be in your opinion a wise thing to do.

Mr. VOLCKER. I do not know how much I can help you in terms of specifics, Mr. Bailey. I share most of the philosophy that you were expressing. I think you have a budgetary problem. If you are correct that you cannot do it on the spending side, you have to turn to the revenue side, and I expressed a general approach that you have, I think, accurately repeated.

That does not mean you cannot do anything with the personal income tax. There are a lot of provisions in the personal income tax, and you touched on some of them, where you might raise some revenues.

Mr. BAILEY. The chairman is usually pretty quick with my time. Let me interrupt you on that one thing.

I am very glad to hear you say what you just did. In other words, you would probably feel that some of the movements that we made in making money available in the savings area and some of the recommendations that this committee made, that would encourage business investment or perhaps in your mind, looking at that long-range problem, let us go out there 10, and 15, and 20 and 30 years, look at what the Japanese are doing, let us look at what Europe is doing, let us look at what is happening in the Third World, that those were proper directions and proper moves.

Mr. VOLCKER. It is a question of how far, how fast.

Mr. BAILEY. You think those were good moves?

Mr. VOLCKER. I am not going to give a blanket comment on that complex tax bill, but I think the thrust of it was to try to help on the productivity/incentive side, and that thrust is appropriate. That does not mean that every provision of that bill is ideally suited to that broad result.

Mr. BAILEY. If that thrust was appropriate we would not want to interfere with it.

Mr. VOLCKER. I was not crazy about, to take an extreme example, the all-savers certificate. That I think will do very little for savings.

Mr. BAILEY. I understand that. And the same comments on minimum corporate tax would be helpful.

Mr. VOLCKER. I do not know enough about that, and I would not make the same comment about that, I do not think.

Chairman ROSTENKOWSKI. Mr. Shannon will inquire.

Mr. SHANNON. You don't seem surprised at the shape the economy is in today. Are you?

Mr. VOLCKER. To a degree, but I am not surprised that changing the inflationary trend of 20 years causes some problems and some pain. I have said so consistently, I think, in recent years; in that sense I am not surprised.

Mr. SHANNON. You have been very consistent in the past couple of years you have been coming here. You have been very consistent and stuck to the same course, I think, in every appearance you have made before this committee. I guess what I would like to know is at what point do you determine, at what point does Paul Volcker determine, that the unemployment rate is unacceptably high and we need a change of course?

Mr. VOLCKER. I don't know what you mean by change of course. I think it would be a great mistake to change course in the broadest sense—in terms of concern about turning around the inflationary trend—because I think you are just asking for more unemployment problems and more stresses and strains in the future.

I wouldn't exactly call it changing course. You always have to make a judgment about what is precisely right in terms of monetary growth, let's say, which is directly under our purview. Obviously we keep that under review, but we keep it under review in the context of the overall effort to deal with the inflationary problem.

Mr. SHANNON. Let me ask you this. Given the economic policy that is in place now and your ideas, and I understand you cannot make long-term projections as to what you might or might not do, where do you think the rate of unemployment will go before it starts to come down?

Mr. VOLCKER. It had what I assume is an aberration last month, a drop to about 8½ percent, as I recall it. We have been assuming, with a lot of other people, that a rate of 9 percent or more is probable for some period of time simply because, if for no other reason, the unemployment rate will tend to lag even if the economy begins to recover fairly soon. That is not outside the range of what has been reached, obviously.

Mr. SHANNON. Is 10 percent unemployment inconceivable to you?

Mr. VOLCKER. I don't know that it is inconceivable. I do not expect it.

Mr. SHANNON. And how long do you suspect that policies we have in place now would keep the rate of unemployment over 9 percent?

Mr. VOLCKER. The unemployment rate typically responds sluggishly to a business expansion, so you wouldn't expect it to go down very sharply in the initial stages of expansion. You are really asking me a question, I think, as to what the prospects are for an early, strong and sustained expansion, and I simply must say that I think you have a lot to do with that in terms of the fiscal position of the Government.

Mr. SHANNON. You came in last year, I remember, when we were talking about the tax bill, and you were very, very strongly supportive of the effort to cut the budget. But you were not very critical, it seems to me, not critical at all, of a tax bill that many of us felt was going to lead us to the present position that we are in.

Would we be in better shape had we passed a 1-year rate reduction and a more moderate business tax reduction last year?

Mr. VOLCKER. I think we would be in better shape if the spending side of the budget were brought into consonance with the revenue side. You can do that in either direction, obviously. But I think the implication of that tax bill—and what I argued last year, I am sure you will recall—was that if you were going to have that big of a tax reduction—and I was not in favor of that size of tax reduction—but if you were going to have that big of a tax reduction, you were taking on a very large burden of expenditure cuts to bring the budget into equilibrium.

Mr. SHANNON. Well, given that there is a consensus here that the President's proposed budget cuts are not likely to be adopted, would you advise this committee to begin trying to find ways of raising new revenues?

Mr. VOLCKER. I think you have to if that is the conclusion. I do not necessarily accept that as a conclusion. I would hope what the Congress would do, whether they like the President's cuts or some other cuts——

Mr. SHANNON. Well, it is clear that we are not going to approve these budget cuts. If that is clear, should we try to find new revenues?

Mr. VOLCKER. If you tell me—and it is your statement, not mine—that there is no chance of Congress cutting the budget to the extent the President has proposed on the spending side, you have to look at new revenues.

Mr. SHANNON. We have to look for new revenues and we should begin doing that now.

Mr. VOLCKER. Yes. I think if that is your conclusion, you had better begin looking now.

Mr. SHANNON. I just have a few seconds left. Is the climate for business investment better in the United States today than it was 2 years ago, in your opinion?

Mr. VOLCKER. I don't know how to answer that. Right now we are in a recession and the climate is never highly desirable right in the middle of a recession. If you ask whether it is fundamentally better, I would hope it is for a number of reasons.

Mr. SHANNON. If I can just take 5 more seconds, let me ask this question. In your testimony you referred to the lack of confidence that these projected long-term deficits have created in the financial community. Are they more than offset or less than offset by the lower tax rates that we have after last year's tax bill? In other words, we have dramatic reductions in tax rates businessmen and investors are going to have to be paying. Doesn't that provide more than enough incentive, even with the projected deficits that we have, to encourage investment?

Mr. VOLCKER. My reference was, of course, to the uncertainty in financial markets, which is expressed partly in high interest rates. That in itself offsets the stimulating effects of the lower taxes.

Where that precise calculation lies at the moment, I don't know, but what we would like to have is lower interest rates.

Mr. SHANNON. Are we better off with present interest rates and present tax rates, or were we better off with 1979 interest rates and 1979 tax rates?

Mr. VOLCKER.We cannot go back.

Mr. SHANNON. Maybe we can.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Hance will inquire.

Mr. HANCE. Mr. Chairman, I appreciate the opportunity to ask you a few questions. Suppose Congress passed a budget which cuts spending as much as the President's—it might be in different areas. Suppose that, in addition, it cut defense spending by $7 billion in 1983 and by $10 billion in 1984; and entitlements were frozen and there were no cost of living adjustments for any Federal programs. And suppose it contained an oil import fee of $5 a barrel and doubled the excise tax on alcohol and tobacco? With the combination of all that, you would reduce the deficit to $40–$50 billion. What would the effect be on interest rates?

Mr. VOLCKER. Down.

Mr. HANCE. Dramatically?

Mr. VOLCKER. You added all you proposed together with everything the President has proposed?

Mr. HANCE. Right.

Mr. VOLCKER. I think that would have quite a dramatic effect, yes.

Mr. HANCE. Thank you very much.

I yield back the balance of my time.

Chairman ROSTENKOWSKI. Mr. Pease will inquire.

Mr. PEASE. Thank you very much, Mr. Chairman.

Chairman Volcker, I presume you would agree that it is useful in government, as in business, to operate from a factual basis.

Mr. VOLCKER. As much as we can. We are forced to operate on the basis of some assumptions and projections as well.

Mr. PEASE. I am concerned that last year when the Congress was asked to adopt the economic recovery program which is now in place, OMB and the President were putting out projections for the out years which called for a balanced budget by 1984, a $43 billion deficit for fiscal year 1982, and now the administration agrees that those figures are way too low.

CBO and other economists at that time were putting out figures which turned out to be low also, but much more accurate. At the time, last July and August when the President and OMB were submitting their figures on budget deficits, did you have an opportunity to analyze them and did you agree with those figures?

Mr. VOLCKER. We looked at the figures. I thought they were on the optimistic side last year.

Mr. PEASE. Did you have an opportunity to state that publicly?

Mr. VOLCKER. I think I probably did.

Mr. PEASE. Well, I would hope you would. Obviously you are reluctant to interfere with the legislative process, but you and your colleagues on the Federal Reserve Board are left dealing with the problem if Congress is too optimistic. This year the President is proposing a $93 billion deficit for fiscal year 1983 and forecasting

that that will go down every year for the next 5 years. CBO and other economists are saying the budget deficit will be much higher even if the President's cuts are achieved, and that the deficit will rise every year for the next 5 years.

Which do you think is more accurate?

Mr. VOLCKER. Those differences, as I recall, were not huge if you assume either the President's program is fully enacted or compare both sets of projections assuming none of it is enacted. I would assume the more cautious outlook. In other words, the deficits might be bigger on given assumptions.

Mr. PEASE. Yes. Well, I appreciate that. I just hope you would have a chance to speak out on that because one reason we are in the fiscal situation, the deficit problem we have today is that Americans were told and believed the optimistic figures of last summer, and it would certainly be helpful if you were able to ride a balance in terms of telling the people what they are likely to face over the next 5 years.

Mr. VOLCKER. In fairness, Mr. Pease, those projections that the administration presented last year for a balanced budget in 1984 did assume a lot of actions—"savings yet to be proposed" and maybe even some revenue actions—which, as I recall, added up to something like $70 or $80 billion.

They were assuming that some initial action would have to be taken to achieve those figures. Apart from that, projections have deteriorated somewhat.

Mr. PEASE. Let me turn to the discussion you have had earlier with other members of the committee about the need to reduce the deficit over the outyears. I agree with you that action to increase taxes in this calendar year would probably not be wise. You seem to prefer stressing cutting spending rather than increasing revenue as a way of narrowing that gap, and I can understand that. But let's assume, as I think is fair, that there will not be sufficient budget cuts to narrow the gap below $100 billion.

The question becomes a trade-off for fiscal year 1983 and 1984. Are we better off increasing revenue by $30 or $40 billion, reducing the deficit, or is that action likely to be a drag on the recovery so that it cancels out whatever gain we hope to get?

Mr. VOLCKER. I think if you make the assumption, which is your assumption, that you just cannot do it on the spending side, then you have to look at the revenue side. It will not be a drain on recovery. We are in this situation that we didn't assume we would be in—where the budgetary situation is worse than it used to be—where the prospect of those big budget deficits itself is a drag on recovery through its impacts on expectations on present financial markets, and the reality of the pressure it would bring on markets as recovery proceeded.

I think you want to get those deficits out of the way in terms of sizable reductions as the recovery proceeds to help assure that the recovery will take place. I think that is an important factor in promoting recovery, not the opposite. I think the threat is that those big deficits hanging out there will impede the recovery.

Mr. PEASE. Thank you very much.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Frenzel will inquire.

Mr. FRENZEL. Thank you, Mr. Chairman.

Chairman Volcker, thank you for your testimony. I am sorry I have not been here for the whole time. It is always fun for somebody who is often blamed by his constituents for all of the world ills to face perhaps the greatest scapegoat in Washington. I take some comfort in the fact that you endure more arrows and slings, probably, than all of us collectively and you do it very well.

Referring to page 6 of your testimony, there is the statement in there about, I think your phraseology is a tight fit in those ranges, suggesting that your ranges are predicated upon a continuing decline in the rate of inflation, and should the rate of inflation decline, slow down or if it disappears, then may we assume that you are going to have to change your range targets?

Mr. VOLCKER. No. The range is purposely a tight fit to encourage the decline in the inflation rate, which I think is fundamentally necessary.

Mr. FRENZEL. I would agree, but in listening to some of the questions that this committee puts to you, perhaps we will not get to the $92 billion deficit. Perhaps it will be much larger. There seems to be at least suggested possible lack of will on the part of Congress to make the cuts. Suppose that the inflation rate does not continue to decline.

Mr. VOLCKER. We will be in more difficult economic circumstances, but that does not challenge the basic necessity of having to deal with that inflation problem.

Mr. FRENZEL. My guess is that you have to tighten up on those targets in that case, don't you?

Mr. VOLCKER. I would have to look at what else is going on. I don't think sanctifying an increase in inflation by raising the targets is an answer. I don't expect that to happen.

Mr. FRENZEL. It probably is not a useful exercise to engage in a lot of hypotheticals, but in past years the Fed has been the only "Dutch boy" with the only finger in the inflation dike, and I guess the point I am making is one that you made in your testimony, that we cannot do it unless there is a responsible fiscal policy to back a responsible monetary policy.

In the statement of yours on page 7 that the financing load for 1982 should be manageable in the context of reduced credit demands by other sectors, can you explain those reduced credit demands?

Mr. VOLCKER. I could explain it. In the business sector the credit demands in fact are not declining as rapidly and as sharply as you would perhaps expect in a recession. But if you look at the housing area, for instance, maybe it is not correct to say the credit demands are reduced, but certainly the amount of credit being provided for housing is sharply reduced. That sector is squeezed out. You will find, even with that deficit, that the overall demand for credit that actually materializes in the market won't be exceptionally large this year because private demands, particularly mortgage demands-and to some extent business demands—will go down.

You do not like that to happen ordinarily.

Mr. FRENZEL. You bet you don't.

Mr. VOLCKER. In the middle of a recession, maybe that is OK, but you do not want that to happen during a recovery period or you will not have the recovery.

Mr. FRENZEL. If there is a recovery, obviously the demand for private credit increases.

Mr. VOLCKER. You better get the Government out of the way.

Mr. FRENZEL. So that runs us right back into the interest rate noose unless the Government can manage to disengage itself from some of its credit activities.

Mr. VOLCKER. Right.

Mr. FRENZEL. And that is the problem with not cutting spending.

Mr. Chairman, you have hit your money target pretty well for the year, but during the year there have been fairly dramatic fluctuations in the money supply, which we are told tend to aggravate psychological dysfunctions in the market, which exist anyway. Do you have the amount of weaponry necessary to control the supply to your satisfaction in a way that you can execute responsible monetary policy?

Mr. VOLCKER. I think we have an adequate ability to execute what I think of as a responsible monetary policy. We do not have the tools in place to produce an absolutely stable monthly M_1 figure, let's say, but that is not particularly desirable anyway.

Mr. FRENZEL. Good. That is the way I feel, too. I thank you for your testimony. My time has expired, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Anthony will inquire.

Mr. ANTHONY. Thank you, Mr. Chairman.

Mr. Volcker, welcome before the committee. I must admit that I have been a great admirer of yours, and I think Mr. Frenzel hit it right on target when he said that you have been the point person for an awful lot of criticism. As I have traveled back into south Arkansas, your name has been mentioned as often as President Reagan's name has.

I would just like to share with you some of the viewpoints that have been given to me and have you respond to them. In 1981, most of the business people agreed that we needed to be running a tight monetary policy but they felt that the Fed was running too tight on its monetary policy to the extent that it was choking back growth. These are people in the timber industry, the housing industry, the real estate industry, and they felt as a result that they were being picked out and being punished as an industry because of that policy. I just wondered if you can respond to them.

Mr. VOLCKER. You can always have a legitimate debate about whether the policy is a little bit too tight or too easy. But is that industry being picked on? I think the way things are structured in this economy and structured in the financial markets, they are at the end of the whip, so to speak. If you have a problem in financial markets, it is those sectors of the economy that feel it the most.

I don't think we can, as a matter of practice, and certainly not in terms of our objectives of dealing with inflation, provide relief through monetary policy. If we tried to do so, we would have a bigger problem, and I think that industry would have a continuing problem. Their hope has to be that we can get a handle on this inflationary situation. I think we are beginning to do that, and that

is the big prize out there, for them in particular, at the end of this process. Something can be done.

That sector has the biggest draft, in effect, on the savings potential of the American economy. If you are going to preempt it with Government deficits and to the extent you preempt it with Government deficits, you are putting the pressure back on that sector of the economy that is most vulnerable to financial market pressures and high interest rates. That is a very direct way of putting the issue before you.

Mr. ANTHONY. I think that's an excellent answer and it's almost the answer I gave them. But since they are on the end of the whip and knowing now that the S. & L.'s are in disastrous shape—Brookings estimates that 1,000 may go under or be merged out by the end of 1983—we know that the housing industry is absolutely on its knees. The homebuilders, are all coming to Washington now and they are thinking, since they're not going to get any relief on the monetary side, albeit inflation is going down, interest rates are still high, that they are going to have to get some help out of the Congress.

Now in trying to gel what they are going to ask the Congress to do, be it $9 billion to help bail out the S. & L.'s, some immediate housing program to bail out the housing industry on the fiscal side, then squaring what you say in the out years in 1983 and 1984, I take it then that if we offer these industries some help, you are saying that we should have a dollar-for-dollar lateral shift out of some other Government programs, not expand Federal spending, but in fact curtail Government spending, so that if we help those industries who are at the end of the whip on the fiscal side out of the Congress, we are going to have to set some priorities and we are going to have to say OK, if you are at the first of the whip, you are going to have to share some of the pain with the people at the end of the whip.

Mr. VOLCKER. Right. I think that's the nature of the problem you have, yes.

Mr. ANTHONY. I think that is what I heard you say and I think that is probably what is going to be facing this Congress in 1982, in order to try to save some of these basic industries that probably will go out before the light shows out at the end of the tunnel.

Mr. VOLCKER. But let me say, too, that if we are at all successful, when it comes to monetary policy as well as to fiscal policy and all other policies, the very severe problem that the savings and loan industry and the housing industry face should be a short-term problem; it should not be a problem for 1984.

Mr. ANTHONY. Well, I would hope that it would not be a problem for 1984 because it has been a problem since 1979.

Mr. VOLCKER. It is a problem for 1982, certainly.

Mr. ANTHONY. Yes. They have already lived through more than most people should be required to live through.

Mr. VOLCKER. That is correct.

Mr. ANTHONY. I have another problem with it and I guess this is what I would ask you to consider as you go through your policy for 1982. If you could operate your policy at the midrange or at the upper range of your tight monetary policy, they may see some hope

of holding on through 1982 so they could be in business so that they could enjoy the recovery in 1983 and 1984.

Chairman ROSTENKOWSKI. Mr. Ford will inquire.

Mr. FORD. Thank you, Mr. Chairman, and I too would like to welcome you, Mr. Volcker, to the Ways and Means Committee.

You mention in your testimony that we see clear signs of progress on the inflation front. Also in your testimony before the committee you talk about the huge 1982 deficit to the tune of $100 billion.

Now Mr. Chairman, the area that I represent, and I am sure it is like most urban areas throughout this country, people back home are saying yes, we would like to see the inflation rate continue to drop, but the small businesses back home, they are complaining about the high interest rates. And I know that we have discussed with my colleagues here on the committee about some of the problems with the huge deficits which we will be faced with in 1983, as well as 1984, and the unemployment problem that we are faced with.

But I still am not clear as to what I can say to the people that I represent back in Memphis, Tenn., as to what is going to happen with the high interest rates and what the small businesses in this country can expect from their government.

I know that you have tried to respond to this both on the Senate side and the House side, but it is still a problem that the small businesses are faced with.

Mr. VOLCKER. I hear this question every day when I meet with small businessmen, farmers or homebuilders. I tell them that I have not got any magic solution for their problem in the short run. I know that the solution for their problems over a period of time rests fundamentally on dealing with inflation, and if we let this get out of hand again, we are going to be in a much more difficult situation for dealing with it.

It is no comfort in the short run, but we have been through this kind of period before, and in a sense we have said, "Let's forget about inflation"—that's overstating it a little bit but not by very much—"there are other priorities that we have to deal with." We ended up, as a result, with more inflation and more problems. The recession has come quicker and the interest rates have gone higher. That doesn't solve those problems for any period of time.

What we would be doing if we did that again, it seems to me, is a great disservice by trying to put a band-aid on the situation, in order to provide what would be a false hope for a few months, until the situation deteriorated again.

We are trying to turn a corner toward a real prospect of fundamental improvement for years ahead, not for 3 months.

Mr. FORD. What did you mean in your statement I think on page 7 when you say the $100 billion deficit for 1982 "to a large degree, will act as an automatic stabilizer".

Mr. VOLCKER. If you look at that deficit in 1982, there is some component, but a relatively small component, of what I would think of as a structural deficit. The budget in 1982 is being affected by the decline in revenues, to some degree by an increase in expenditures for unemployment compensation, for instance—by fac-

tors that are a direct reflection of the business situation that we are in.

Those expenditures and the shortfalls in revenue to some extent support income and support business activity and support consumption.

The financial market effects work in the other direction but, in fact, as we were discussing earlier, private credit demands are not so big. In concept, at least, that should not present as big a problem in squeezing out other investment as during a year——

Mr. FORD. But that is not to say it is not a problem for 1982 at the tune of $100 billion, is it?

Mr. VOLCKER. That $100 billion in 1982 does not mean the same thing as $100 billion in a good business year. In a good business year $100 billion means you have a horrendous structural deficit, and that is the prospect you are looking at—more than $100 billion when you get out to 1984 or 1985. That is quite a different deficit than $100 billion in 1982.

You have a structural deficit looming ahead, not just a cyclical deficit. This year has some elements of a structural deficit, but it is mostly cyclical. When you look out ahead, it is all structural.

Mr. FORD. Well basically what you are saying also in your testimony is that you support the concept of the budget cuts that have been proposed by the administration; is that correct?

Mr. VOLCKER. I support the notion that you have to worry about defense, you have to worry about social priorities and all the rest, but from an economic standpoint, yes, priorities certainly should be on the spending side.

Mr. FORD. Mr. Volcker, did you support the tax package that was before the Congress in the last session, when the administration proposed it? I think at first it was the Kemp-Roth and then I think it——

Mr. VOLCKER. I do not think I would characterize my attitude as having been supportive.

Mr. FORD. Thank you. My time has expired.

Chairman ROSTENKOWSKI. Mr. Holland will inquire.

Mr. HOLLAND. Thank you, Mr. Chairman.

Mr. Chairman, I take it that you say that most of our Nation's economic ills are because of the congressional habit of spending. Is that a fair interpretation of what you have been saying all morning?

Mr. VOLCKER. Most of the Nation's ills? That is a little too simple.

Mr. HOLLAND. Well, I am trying to get it down to the basic terms because the next question will tell you why.

Mr. VOLCKER. I think one element in our problem, and a particularly important element as we look ahead, has been the fiscal position of the Government, yes.

Mr. HOLLAND. Yesterday, Senator Baker proposed a corporate surtax to finance some of this debt. What is your opinion of that proposal?

Mr. VOLCKER. I do not feel able to comment on a proposal of that sort, partly because I have not looked at that one or analyzed at all, but also because I think on that kind of specific tax decision or

spending decision you have to ask: If not that, what else? It is always a matter of relatively good or relatively bad.

I do not think I have any special expertise to bring to bear.

Mr. HOLLAND. I thought I heard you say a while ago in response to Mr. Hance that if we could raise revenues and get that old debt down to about $40 billion, you thought it would have a dramatic effect on interest rates.

Mr. VOLCKER. Yes, sir.

Mr. HOLLAND. Well, wouldn't the corporate surtax raise the same kind of revenues he was talking about on tobacco and alcohol and $5 a barrel on imported oil? A corporate surtax would add money to the national coffers, wouldn't it, and have the same propitious results you describe in response to Mr. Hance?

Mr. VOLCKER. I do not know what the numbers are and what kind of a surtax it would take to produce the revenues, but assuming the revenues are the same, it could have an effect on financial markets. But you have to look at the other dimensions, too; what does it do to incentives, corporate costs, and all the rest? I just do not know what particular proposal you have in mind.

Mr. HOLLAND. I don't have one. Senator Baker has it. I think the source of it is very interesting. Suppose it said that no more than 50 percent of any deficit enacted by the Congress could be financed by borrowing, and the rest would be paid by a corporate surtax. That would cut your deficit immediately in half.

Mr. VOLCKER. It would appear to cut your deficit in half. You are talking about a tremendous corporate tax.

Mr. HOLLAND. Assuming we passed the administration's tremendous deficit, then you are talking about a horrendous corporate tax.

Mr. VOLCKER. A corporate tax of that nature—I am just responding to your hypothesis—would raise some questions apart from its revenue impact.

Mr. HOLLAND. All right, sir. I have a political problem with the interest rate. I do not envy your situation because you are possibly even more maligned than the Congress these days by the business community. You get all the blame for the high interest rates and I am sure you understand that.

And the little businesses, the car dealers and little dry cleaners establishments that want to increase their activities say that the reason they are folding and cannot go on is because of the high interest rates and that old Volcker up there and his Federal Reserve crowd.

And what I would like for you to tell me, because I have told them I was going to ask you and then I was going to come back and tell them, is how do you suggest we in the Congress respond to the average business person out there who is literally going bankrupt for inability to borrow operating capital? They are not blaming that on the Congress. They are blaming it on the Federal Reserve.

I want to go back and defend you if you will just tell me what to tell them.

Mr. VOLCKER. I would like you to tell them that we really are their greatest friends because we are going to deal with this infla-

tionary situation and in time that is going to bring interest rates down and produce environment in which they can live and thrive.

From the standpoint of your own contribution, I think that that is obvious. To the extent that you can deal with this deficit, you are helping them. And I do not think there is any magic, easy solution to this problem.

Mr. HOLLAND. It is difficult, though, to look a builder or a real estate person or an automobile dealer in the eye and tell them in some glorious day in the future, maybe next year or the year after, all this is going to pay off, except they come right back and say but next week or next month I am going to be bankrupt and down the tubes, so it does not really make a damn to me. They want to know what we are going to do right now.

Can I go back and tell them that the Federal Reserve—I know the Reagan administration has no instant response to that today, but the Federal Reserve says we are going to have to hold out and pull on the long haul; is that a fair response to give them from you?

Mr. VOLCKER. That is one way of looking at it. I hope the long haul does not have to be all that long, and obviously I do not want to play the record too many times, but you do have something to say about that. I think we do have to stick with it, and I do not think that necessarily means that these interest rates are going to remain at these levels.

Part of the reason they are at these levels is because of uncertainty about whether we are going to stick with it, and as long as that uncertainty exists, we all prolong their agony.

Mr. HOLLAND. We all prolong it. Thank you very much. I appreciate your statement today.

Chairman ROSTENKOWSKI. Mr. Gibbons will inquire.

Mr. GIBBONS. Thank you, Mr. Chairman.

Mr. Volcker, you have been here a long time and I am sorry I missed the first part of your testimony, but I was off dealing with a problem that is to some extent caused by our country's monetary policy, and that is our horrendous trade deficit with Japan. We were working with Japanese legislators this morning and hopefully we can report something positive soon.

As you pick out the problems of this country, the economic problems of this country, how do you rank them? What is the No. 1 economic problem this country has? Is it inflation? Is it high interest rates? Is it the deficit? Is it Congress inability and the administration's inability to control the budget? What is the biggest economic problem this country has?

Mr. VOLCKER. Of course all these things are interrelated, Mr. Gibbons, but I would think that underlying the very intense immediate problems we have now is a whole course of developments that took place over a decade or two decades or more, many of them manifested and reflected and promoted by the inflationary process.

In a fundamental way, I think I would rank that as No. 1.

Mr. GIBBONS. So inflation is now and has been the biggest economic problem we have?

Mr. VOLCKER. I think that is right, looked at over a span of years.

Mr. GIBBONS. Let me go to some specifics now. You are always looking at monetary markets and one of the proposals that the President has made had to do with tax-exempt revenue bonds. Have you looked at the proposal that he has made?

Mr. VOLCKER. No, I have not looked at it in detail. I am aware there is an awful lot of financing being done by tax-exempt revenue bonds, and that market is very congested.

Mr. GIBBONS. Would it be your recommendation to us that we ought to uncongest that market?

Mr. VOLCKER. Yes, not giving you an official Federal Reserve position but speaking as one who has looked at this in the past, yes.

Mr. GIBBONS. Well, I am kind of relying on your vast experience. What should the Congress be doing right now?

Mr. VOLCKER. Working on that budget.

Mr. GIBBONS. Doing what to it?

Mr. VOLCKER. Dealing with the structural deficit that exists out there in 1983, 1984 or 1985 by whatever measures you think most appropriate in terms of social and other priorities that exist—but doing it.

Mr. GIBBONS. Even with full employment and with a functioning economy, we are going to have a structural deficit?

Mr. VOLCKER. Yes.

Mr. GIBBONS. Very large.

Mr. VOLCKER. Yes.

Mr. GIBBONS. How large is this structural damage in the outlying years, with full employment and a properly functioning economy?

Mr. VOLCKER. I think you have a pretty good measure of it when you look at the administration or the CBO projections. After a few years of assumed good growth, you still have a deficit in the $150, $160, $170 billion area.

Mr. GIBBONS. You would say that that is the motivating factor for the inflation premium that interest rates are now having?

Mr. VOLCKER. Part of it. Not all of it, but some of it.

Mr. GIBBONS. Thank you, sir.

Chairman ROSTENKOWSKI. Mr. Archer will inquire.

Mr. ARCHER. Mr. Volcker, I am told by many of the banks that their interest rates are set based on the cost of their money and that a big portion of this is today coming from Fed funds, particularly for some of the larger banks, that a big part of their funds is coming from Fed funds so that the Federal Reserve sets the rate on those funds.

Is that correct?

Mr. VOLCKER. Not in any direct sense, but the Federal funds market is a market for trading one-day money among banks, largely; the scarcity or plenitude of that money on a daily basis is certainly influenced by our operations, but we do not set the rate.

Mr. ARCHER. Well, I am told by some of these bankers that your actions definitely do determine what the rate on Fed funds is.

Mr. VOLCKER. They certainly influence it in the short run.

Mr. ARCHER. How can we have the kind of growth that we need in this country with the kind of interest rates that we have today relative to the rate of inflation? You know, if inflation were running today at 16 percent, then you could perhaps understand why you would have a 17-percent interest rate. I am not talking about

long-term rates. I am talking about short-term rates, which are not influenced on the basis of inflationary expectations because you are going to get your money back before inflation can really have any effect.

Now I do not understand this and I have not talked to anybody who understands it and maybe you do, and if you do I certainly would like to know the answer.

Mr. VOLCKER. In broad terms, you have a lot of pressure on monetary policy. You have a relatively restricted volume of money for the amount of business taking place. I am not explaining why it is higher this week than last week, or lower last month or last quarter. Those movements are hard to predict and can only be explained ex post.

I think, in general, it is fair to say that we are restricting the supply of money relative to what people would like to have, relative to what the economy would like to operate on. Given the current rate of inflation, given the current level of economic activity, that tends to keep interest rates higher than they would otherwise be in the short-term area, as you properly emphasize.

Mr. ARCHER. Well, I appreciate your candor and I understand the great problems you have and I am one who has always not wanted to have an expansive money supply that would bring on greater inflation over the long term, as you have adequately pointed out. But I am terribly concerned today about what we see not only in this country but in the world. I do not think there is any question but what we can wring inflation out of the marketplace, but at what price and at what cost if we do it just through money supply?

We have unfortunately, and I disagree with this. I am ready to vote the spending cuts. I will vote them and not look back because I think it is important, as you pointed out. But the Congress is obviously not going to do that, and that is too bad, but the consensus is not building in the Congress to make the kind of cuts in Federal spending that we need to make.

Now one of those areas that we need to cut is the interest on the national debt, too, which would be very helpful. And I understand it all falls together.

Now in view of the fact that the Congress has obviously not got the political courage to get after the entitlement programs and a lot of other things that we need to get into if we are going to put a real reduction on spending, then this burden is coming onto you. I understand that.

But what bothers me is that if you take it as your sole responsibility to stop inflation, you can wring it out. We will have 30 percent interest rates and 20 percent unemployment and so on and it is a pyrrhic victory. And it bothers me when I hear that the money supply increased at the greatest rate historically in this country in the months preceding the 1980 election and then immediately after the election the valve was shut tight.

And to have this kind of a roller-coaster thing it seems to me is not beneficial to the best long-term interests of this country.

Mr. VOLCKER. That had nothing to do with the election, that particular fluctuation. We had a fluctuation recently because there are an enormous number of forces bearing upon the shortrun movements in the money supply. In that period in late 1980 we

were applying restraining pressure rather continuously during the fall, both before and after the election, just as we did in January or February of this year.

The general problem you outlined, which is obviously very real, cannot be escaped in my judgment by simply increasing the money supply. You could say, on the basis of the analysis that I gave you, that increasing the money supply should reduce short-term rates, and that is good, orthodox economic analysis. The problem is that in current conditions if that same increase in the money supply increases the inflation, it is not going to be very long before you have that same supply-and-demand relationship that you have now, only at a higher level of inflation, and that would gain you nothing.

In terms of expectational effects—and these can be on short-term markets as well as long-term markets, although they are more appropriate in terms of long-term markets—the time gap between trying to push down interest rates by increasing the money supply and the end result of having more inflation and higher interest rates may not be very long.

Mr. ARCHER. I see that I am out of time. I have many things I would like to ask you. One quick question, Mr. Chairman, if I can be indulged in this.

I understand before I got here you said you did not favor any kind of a tax increase, that you are not at all concerned about the $91 billion deficit that is in the budget.

I'm sorry, that is probably unfair, but do you think we have to accept that perhaps at this time. Do I understand incorrectly?

Mr. VOLCKER. You certainly do not understand correctly. That was not the thrust of my testimony at all. You may be referring to the deficit for 1982. I do not think there is much, as a practical matter, you can do about the deficit in 1982. I think you have an enormous problem in 1983–85.

Mr. ARCHER. Well, let me restate my question, then. If we had to choose between having a $91 billion deficit in 1983 or raising taxes, what would you prefer to see the Congress do?

Mr. VOLCKER. Raise taxes.

Chairman ROSTENKOWSKI. Mr. Gephardt will inquire.

Mr. GEPHARDT. Thank you, Mr. Chairman.

Mr. Volcker, there is a lot of criticism today about how you are implementing monetary policy. A number of people in and out of the administration say that if you constructed a smoother path toward restraint of monetary supply, that we would not have problems. I think the previous questioner, Mr. Archer, asked a similar kind of question.

Some people have suggested that you could change the mechanics of what you are doing and that would help. Others say that if you dealt with the monetary base as opposed to the tools you are dealing with, that that would solve the problem.

How do you respond to those criticisms?

Mr. VOLCKER. Let me say, first of all, that no one would be more delighted than I if the money supply developed in a nice even way from week to week or month to month; nobody would raise any questions and everybody would be happy and we could forget about this line of questioning.

The real world does not operate that way and I think events show that quite clearly, whether you look at events here or look at events anywhere else.

In the short run, the money supply tends to be heavily influenced by shifts in the way people want to hold their assets; they hold a little more money or they hold a little less money, depending upon a lot of developments.

I conceive of our job as trying to keep that on an appropriate trend over a period of time in terms of the effort to deal with inflation and our other economic problems.

To the extent we use or develop techniques to enforce more rigidity on the money supply in the short run, I think it is pretty clear we would have more interest rate instability. If people want to hold more money for whatever reason in the short run and we have strict enough control over the supply—in effect we do not let them hold what they want to hold—they are going to demand very high interest rates; that is the way the adjustment is made, or vice versa if it is going down.

You have a question as to whether it is really worthwhile to impose that much more additional instability on the money markets in an effort to get a smoother money supply figure. I do not think that's a very good tradeoff.

Mr. GEPHARDT. I take it you do not think that controlling the monetary base, which I guess you could do in a more even way, would change the volatility of the money supply?

Mr. VOLCKER. I think, then, we would clearly get volatility in the money supply and in interest rates because the relationship in the short run between the monetary base and the money supply is not very good.

Mr. GEPHARDT. Do you believe that you now have an agreement with the administration, or to put it another way, do you believe the administration is now satisfied with the way that monetary policy is being implemented and is satisfied that if we can take actions here, as you have suggested today, that we will more or less work out way out of these economic problems?

Mr. VOLCKER. You will have to ask the administration about their feelings about the way monetary policy is being implemented. I do not think there has ever been any real disagreement with the administration on the basic thrust of monetary policy; I think that has been apparent in what I have said and what they have said all along.

I do think that you can make a major contribution to the recovery and to sustaining the recovery—and an important ingredient in that is lower interest rates—by dealing with the budgetary problem.

Mr. GEPHARDT. My last question is if you changed your policy back to what it was before 1979 and basically geared your policy to the setting of interest rates, do you really think that would accomplish any lower interest rates?

Mr. VOLCKER. No. Before 1970, policy was still geared toward the money supply. The technique for approaching that target was different and was geared toward the Federal funds rate. You would certainly have more stability, I suspect, in the Federal funds rate in the short run. Whether you would have a better overall result, I

would doubt—which is why we changed our technique—and I would doubt you would have lower interest rates over a period of time, a significant period of time.

Mr. GEPHARDT. I thank you very much for your testimony.

Chairman ROSTENKOWSKI. Mr. Chairman, one more question and then we will let you go.

We have had witnesses stress that deficits do not cause high interest rates and in fact, that the historical record shows no direct association between deficits and interest rates. That comment, at least to me, was quite surprising. I would like you to make an observation on that association if you would, please.

Mr. VOLCKER. You do not see that direct association because too many other things are going on in the economy. The thing that affects the deficit most strikingly on a year-to-year basis—when you look at a chart or look at a series of numbers—is the cyclical influence. What tends to happen is you get big deficits when the economy is in recession, as now; you get recessions for other reasons associated with lower interest rates. If you looked at those charts, you might reach a hasty judgment that the bigger the deficit, the lower the interest rates, but obviously that is not the way the thing really works.

If you try to separate out what you might call the structural deficit or surplus, the underlying position of the Federal Government adjusted for the business cycle adjusted for the unemployment rate, I think any analytic approach to it suggests that the more the Government is borrowing, in competition with others, the higher interest rates are going to be. I do not know of any economist who would deny that in general terms. You can argue about the degree, but I do not think you can argue with the general concept.

Chairman ROSTENKOWSKI. Thank you very much, Mr. Chairman. Paul, it has been a pleasure having you here. You have enlightened us as usual. We appreciate your concern and your contribution.

The hearing stands adjourned.

[Whereupon, at 12:20 p.m., the committee adjourned, to reconvene at 9 a.m., Wednesday, February 24, 1982.]

ADMINISTRATION'S FISCAL YEAR 1983 ECONOMIC PROGRAM

WEDNESDAY, FEBRUARY 24, 1982

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The Committee met at 9:15 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Thomas J. Downey presiding.

Mr. DOWNEY. Good morning. The committee hearing today will involve three individual witnesses. First we will hear from the Director of the Congressional Budget Office, Dr. Alice Rivlin, who will give the committee some guidance as to what exactly is contained in the administration's budget and what the projections realistically look like for the next three years.

At 11 a.m., Secretary Schweiker is scheduled to appear before the committee. We look forward with anticipation to Secretary Schweiker's testimony, inasmuch as virtually all the proposed budget cuts in the committee's jurisdiction fall within the sensitive programs in his Department.

Finally, at 2 p.m., Secretary of Labor Donovan is scheduled to appear to discuss the unemployment situation and the status of the Federal-State unemployment programs.

The chairman had asked me to open today's hearings since he had a 9 a.m. meeting at the White House. He hopes to be here as soon as possible.

Welcome, Ms. Rivlin. If you would, begin your testimony.

STATEMENT OF DR. ALICE RIVLIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE, ACCOMPANIED BY NANCY M. GORDON, ASSISTANT DIRECTOR FOR HUMAN RESOURCES AND COMMUNITY DEVELOPMENT, AND JAMES M. VERDIER, ASSISTANT DIRECTOR FOR TAX ANALYSIS

Ms. RIVLIN. Thank you very much, Mr. Chairman. I am delighted to be here this morning. My testimony this morning will cover three areas: The economic outlook as seen by the CBO and the administration, the budget projections of the CBO and the administration, and revenue and spending options for closing the deficit.

THE ECONOMIC OUTLOOK

The economic forecasts of both the administration and the CBO are in close agreement for 1982. Real gross national product (GNP) is projected to rise by about 3 percent over the year and the unem-

ployment rate is expected to be in the neighborhood of 8½ percent at year's end. The forecasts of inflation and short-term interest rates are also similar in 1982.

In 1983, however, the administration's forecast for inflation and real growth is more optimistic than CBO's. While both forecasts imply virtually the same expansion of nominal GNP, the administration looks for real growth of about 5.2 percent over the four quarters of 1982 and for inflation, as measured by the GNP deflator, to fall to a rate of about 5½ percent. CBO expects real GNP growth to be about 1½ percentage points lower than the administration does in 1983 and the GPN deflator to decelerate by about 1½ percentage points less.

As shown in table 1, the administration's economic assumptions for 1984 and beyond are also more optimistic than the CBO's. Compared with CBO's baseline assumptions, the administration projects higher real growth and sharper declines in inflation, unemployment, and interest rates.

[A table follows:]

TABLE 1.—COMPARISON OF CBO AND ADMINISTRATION ECONOMIC ASSUMPTIONS

[By calendar year]

	1982	1983	1984	1985	1986	1987
Gross national product (GNP):						
Current dollars (percent change, year to year):						
CBO baseline	7.5	11.9	10.4	9.7	9.4	9.1
Administration	8.1	11.5	10.2	9.7	9.2	9.0
Constant (1972) dollars (percent change, year to year):						
CBO baseline	−.1	4.4	3.6	3.5	3.5	3.5
Administration	.2	5.2	5.0	4.7	4.4	4.3
Prices:						
GNP deflator (percent change, year to year):						
CBO baseline	7.5	7.3	6.6	6.0	5.7	5.4
Administration	7.9	6.0	5.0	4.7	4.6	4.5
Consumer Price Index (percent change, year to year):						
CBO baseline	7.5	6.9	6.9	6.4	6.0	5.7
Administration	7.3	6.0	4.6	4.8	4.6	4.5
Unemployment rate (percent, annual average):						
CBO baseline	8.9	8.0	7.4	7.2	6.9	6.7
Administration	8.9	7.9	7.1	6.4	5.8	5.3
Interest rate (91-day treasury bills, percent, annual average):						
CBO baseline	12.0	13.2	11.3	9.4	8.7	8.1
Administration	11.7	10.5	9.5	8.5	7.0	5.5

Sources: "Budget of the United States Government, Fiscal Year 1983," pp. 2–5 and 2–7, and CBO, "Baseline Budget Projections for Fiscal Years 1983–84 (February 1982), p. 15.

Ms. RIVLIN. The administration's real growth assumptions for the period 1984 to 1987 are near the upper end of historical experience. In comparable 4-year periods following previous postwar recoveries, real growth averaged 3.4 percent a year and ranged between 2 and 5.2 percent a year. The administration assumes an average growth rate of 4.6 percent a year between 1984 and 1987. CBO in its baseline projections assumes an average annual growth rate of 3.5 percent, which is about in line with past average expectations.

The slower real growth projected by CBO results largely from the higher real interest rates in the CBO forecast that serve to

dampen the recovery in economic activity. As discussed below, both CBO and the administration project large budget deficits. This will result in a marked increase in Treasury borrowing, putting upward pressure on interest rates. At the same time, the Federal Reserve's targets for monetary growth may act as a brake on economic growth during the next few years. Some analysts fear that the combination of a stimulative fiscal policy and a tight monetary policy will push interest rates to very high levels and thereby limit economic growth. The outcome is very difficult to predict, however, because this policy combination is virtually without precedent. Nevertheless, there is a significant risk that the outcome could be weaker growth than projected by either the Administration or the CBO.

BUDGET PROJECTIONS: CBO BASELINE

As shown in table 2, CBO's baseline budget projections, which are based on a continuation of current tax and spending policies, show the deficit increasing substantially, from $157 billion in fiscal year 1983 to $248 billion in 1987. In all previous CBO baseline projections, revenues grew faster than outlays and the budget began to show a surplus within 2 or 3 years. Projected revenues grew more rapidly than the economy because inflation and economic growth pushed individuals into higher income tax brackets. Projected baseline outlays, on the other hand, grew more slowly than the GNP, because most spending was assumed merely to keep pace with inflation.

[A table follows:]

TABLE 2.—COMPARISON OF CBO BASELINE AND ADMINISTRATION CURRENT SERVICES BUDGET PROJECTIONS, FISCAL YEAR 1982–87

	1982	1983	1984	1985	1986	1987
In billions of dollars:						
Revenues:						
CBO baseline	631	652	701	763	818	882
Administration current services [1]	626	653	704	778	843	907
Outlays:						
CBO baseline	740	809	889	971	1,052	1,130
Administration current services [1]	728	799	869	96	1,019	1,082
Budget deficit (−):						
CBO baseline	109	157	188	208	234	248
Administration current services [1]	101	146	165	168	175	175
As a percent of GNP:						
Revenues:						
CBO baseline	20.6	19.0	18.5	18.3	18.0	17.7
Administration current services [2]	20.3	19.0	18.6	18.7	18.5	18.3
Outlays:						
CBO baseline	24.2	23.6	23.5	23.3	23.1	22.7
Administration current services [2]	23.6	23.3	22.9	22.7	22.4	21.8
Budget deficit:						
CBO baseline	3.6	4.6	5.0	5.0	5.1	5.0
Administration current services [2]	3.3	4.2	4.3	4.0	3.9	3.5

[1] Inlcudes proposed defense spending growth. The administration has also classified certain social insurance contributions as offsetting collections to spending,thereby reducing both revenues and outlays but leaving the deficit unchanged.

[2] Based on administration GNP projections.

Sources: "Budget of the United States Government, Fiscal Year 1983," pp. 3–8, and CBO, "Baseline Budget Projections for Fiscal Years 1983–87" (February 1982), p. 16.

Ms. RIVLIN. The present baseline budget projections are different from those of the past. As a result of the tax cuts contained in the Economic Recovery Tax Act of 1981, baseline revenues grow less rapidly than the economy. Projected baseline outlays still grow less rapidly than the economy, but at a faster pace than revenues. The baseline budget projections are therefore characterized by large and growing deficits.

REVENUES

Baseline revenues are projected to rise from $631 billion in 1982 to $882 billion in 1987, an increase of 40 percent in 5 years. This represents an average growth of 6.9 percent per year, compared with an assumed average growth in nominal GNP of about 10 percent per year. Baseline revenues as a proportion of GNP are thus projected to decline from about 21 percent in 1981 to less than 18 percent by 1987. The decline is relatively rapid during 1982, 1983, and 1984, when staged reductions in individual and corporate income taxes take place. It levels off thereafter, when personal income tax brackets are indexed to the Consumer Price Index in order to prevent effective tax rates from rising with inflation.

OUTLAYS

As to outlays, baseline outlays are projected to increase at a faster pace than revenues. Under baseline assumptions, outlays would rise from $660 billion in 1981 to $740 billion in 1982, and $1.1 trillion by 1987. This represents an average annual growth in outlays of 8.9 percent during the projection period, or about one percentage point less than the assumed growth in GNP and two percentage points higher than the projected growth in revenues. Under baseline assumptions, outlays would decline only slightly as a share of GNP, from about 24 percent in 1982 to about 23 percent in 1987. By 1987, the ratio of Federal outlays to GNP would be about the same as it was in the 1975 to 1980 period, but higher than for the earlier postwar periods.

BUDGET DEFICITS

It follows, of course, that the deficits would grow. Under baseline assumptions, the unified budget deficit would rise significantly through 1984, both in dollar terms and as a percent of GNP. The deficit would equal $109 billion in 1982, $157 billion in 1983, and $188 billion in 1984. As a share of GNP, the deficit would rise from about 3.6 percent in 1982 to about 5 percent in 1984.

From 1984 onward, baseline revenues and outlays would grow at similar rates, and the deficit would stay at about 5 percent of GNP.

ADMINISTRATION CURRENT SERVICES

As shown in table 2, the administration's current services projections, which include their proposed defense spending growth, also show large and growing deficits. With no further spending cuts or tax increases, the administration projects a deficit of $146 billion in 1983, rising to $168 billion in 1985. So the story is roughly the same.

DO DEFICITS MATTER?

The question: Do deficits matter? If the prospective rise in the Federal budget deficit were exclusively or principally a temporary cyclical phenomenon, there would be little cause for concern. Indeed, rising budget deficits during periods of recession serve to limit both the magnitude and the duration of the decline in economic activity. Once the recovery is underway, the recession-induced bulge in the deficit disappears as tax revenues grow and as outlays for unemployment compensation and other programs decline.

Unfortunately, the current budget problem is neither exclusively nor principally recession-related. It is, rather, a problem of chronic prospective budget deficits. Without significant legislative changes in Federal spending and tax laws, the trend appears to be one of large and growing Federal budget deficits, not only during the recovery from the current recession, but for the foreseeable future as well. No clear economic rationale exists for the persistence of deficit spending year after year, and the distinct possibility exists that the very large and rising budget deficits projected for the future could seriously impair the overall performance of the economy.

The increased competition for funds induced by Federal Government borrowing drives up interest rates, crowding out private-sector investment. Ultimately, the reduction in private-sector investment hurts productivity growth and worsens inflation. In the face of chronic budget deficits, these adverse effects are compounded by the further increase in outlays for interest on the Federal debt caused by higher interest rates.

Increased Federal Government borrowing exacerbates inflationary pressures if the Federal Reserve is induced to expand the money supply to limit the rise in interest rates.

SPENDING AND REVENUE OPTIONS TO REDUCE THE DEFICIT: ADMINISTRATION PROPOSALS

So the question is what to do about it. The administration has proposed a series of tax and spending changes that it estimates will reduce the deficit to $92 billion in 1983, $72 billion in 1985, and $53 billion in 1987. CBO has prepared a reestimate of these proposals which will be released tomorrow when I testify before the Senate Committee on Appropriations.

ADMINISTRATION PROPOSALS

The administration's deficit reduction proposals for 1983 to 1985 are concentrated largely on the spending side of the budget. The biggest share of the outlay reductions, 40 percent, would be accomplished largely through the appropriations process, by holding back increases or cutting nondefense discretionary programs. Another 29 percent of these outlay reductions are to be achieved through legislative proposals to cut back entitlement programs, primarily medicare, medicaid, food stamps, and AFDC. No cuts for social security are proposed.

An estimated 28 percent of the outlay savings would be achieved through various management initiatives, such as accelerated leas-

ing of Outer Continental Shelf lands, the sale of surplus or underused Federal property, improved debt collection procedures, and further restraint in Federal pay. Finally, proposed increases in user fees would be counted as an offsetting receipt, making up the remaining 3 percent of proposed outlay savings.

Only a little more than 20 percent of the administration's deficit reduction proposals involve revenue increases. Nearly 75 percent of the increases during the 1983–1985 period would come in corporate income taxes, offsetting about 60 percent of the corporate tax reduction enacted in the Economic Recovery Tax Act for that period. No proposals are made in the February budget to delay or eliminate any of the scheduled rate reductions in individual income taxes that were also enacted in ERTA.

OTHER SPENDING REDUCTION OPTIONS

Given the magnitude of the deficit problem, spending reductions in addition to those proposed by the administration should be considered. Defense spending and major entitlement programs cannot be left off limits if substantial progress is to be made in reducing the deficit.

DEFENSE

As shown in table 3, large potential outlay savings could result from limiting the administration's proposed real growth in defense spending. The administration's proposed defense budget, according to CBO calculations, includes an average real growth in budget authority of about 6 percent a year over the whole 1982 to 1987 period, with a 9-percent growth in 1982 through 1985. Providing a steady real growth of 7 percent in budget authority would reduce outlays by almost $7 billion in 1983 and $11 billion in 1985, since spending would be pushed into later years. This assumes a proportional reduction in all nonpay accounts. Reducing real growth in budget authority to a steady 3 percent over the period 1982 to 1987 would reduce outlays by $10 billion in 1983 and $53 billion in 1987. While the outlay savings are relatively small in the early years, they become much larger in later years. Since the major budget problem is one of chronic long-term deficits, the fact that the outlay reductions are relatively small at the outset does not diminish the usefulness of this option.

[A table follows:]

TABLE 3.—OUTLAY REDUCTIONS FROM REDUCING REAL GROWTH IN BUDGET AUTHORITY FOR DEFENSE [1]

[By fiscal year]

	1983	1984	1985	1986	1987
7 percent real growth	7	9	11	9	1
5 percent real growth	8	14	22	27	28
3 percent real growth	10	19	32	44	53

[1] Based on the administration's February budget request, after adjustment for CBO technical reestimates and inflation assumptions.

ENTITLEMENTS

Ms. RIVLIN. While the administration has proposed some reductions in entitlement spending, other options are possible. Most entitlement programs take the form of Federal benefit payments to individuals. These payments constitute about half the Federal budget—$366 billion in 1982. Of this total, nearly two-thirds goes for retirement programs, the largest of which is social security. Means-tested programs directed toward low-income persons account for only 18 percent of all the outlays for payments to individuals.

The administration's proposed budget for 1983 includes cuts in 18 entitlement programs, with an outlay reduction estimated by the administration of about $12 billion. Over 60 percent of these cuts would affect means-tested programs, including food stamps, medicaid, and AFDC. About 30 percent of the cuts would be in non-means-tested programs, including medicare, Federal retirement, and railroad retirement.

Besides the changes in retirement programs the administration has already proposed, other options could be considered and the scope broadened to include social security. Social security is more than half again as large as all the other retirement programs combined. Since the social security recipient population is so large, the burden of a benefit reduction generating sizable savings could be distributed widely, lessening the sacrifice for each individual beneficiary.

Much of the rapid growth in retirement benefits has resulted from automatic COLA's. In the last 3 years, the CPI has risen faster than wages. Thus retirement benefits have maintained their purchasing power, while wages of the working population have fallen in real terms. In addition, the CPI contains a flaw in its treatment of housing costs which results in overestimating price increases during periods of rapidly rising mortgage interest rates. Consequently, the CPI has risen faster than other price indexes during the last 5 years.

A change in the COLA for retirement programs could achieve large short-run savings. This approach would affect both current and new beneficiaries, thereby spreading the burden widely. Beneficiaries with low total incomes would find it difficult to absorb even a small decline in their real benefits, however.

One potential change in the automatic COLA in retirement programs would reduce the adjustment to two-thirds of the increase in the CPI, with some or all of the remaining one-third granted at the Congress discretion. If this change were implemented with the July 1982 and March 1983 COLA's and no discretionary supplements were provided, savings would be $6 billion in 1983 and $29 billion in 1987, as is shown in table 4.

[A table follows:]

TABLE 4.—ESTIMATED OUTLAY SAVINGS FROM REDUCING COST-OF-LIVING ADJUSTMENTS (COLA'S) IN THE SOCIAL SECURITY, FEDERAL CIVILIAN AND MILITARY RETIREMENT, AND RAILROAD RETIREMENT PROGRAMS [1]

[By fiscal year, in billions of dollars]

	1982	1983	1984	1985	1986	1987
Automatic two-thirds of COLA with no discretionary supplement	1	6	10	16	23	29
Delay COLA from July to October	3	3	4	4	4	4
Skip 1982 COLA	3	14	16	18	20	21
Reduce COLA by 1 percentage point (in 1982 only)	—	2	2	2	2	3

[1] Changes in the COLA's for social security and railroad retirement are assumed to occur in July 1982, whereas changes for the Federal civilian and military retirement programs are assumed to occur in March 1983.

Ms. RIVLIN. Alternatively, smaller savings could be achieved by permanently delaying the annual COLA for social security and railroad retirement from July 1 to October 1. The COLA for civil service retirement, already changed from twice to once a year, could be delayed from March to June. This would be the equivalent of about a 2-percent reduction in benefits, producing savings of about $3 billion in 1983 and $4 billion in 1987. Some other options are detailed in table 4.

OTHER REVENUE INCREASE OPTIONS

Other revenue-increasing options beyond those proposed in the President's budget could also be considered. Table 5 lists a number of possibilities, including scaling back the individual and business tax reductions enacted last year in the Economic Recovery Tax Act and doubling existing excise taxes on alcohol, tobacco, telephones and gasoline. Eliminating the scheduled 1983 rate cut and the 1985 indexing of the individual income tax would increase projected revenues by large amounts—over $50 billion in 1985 and about $100 billion in 1987.

[A table follows:]

TABLE 5.—POSSIBLE REVENUE INCREASE OPTIONS, FISCAL YEARS 1983–87

[In billions of dollars]

	1983	1984	1985	1986	1987
Eliminate 1983 income tax rate cut	9	37	40	44	47
Eliminate indexing	—	—	12	30	51
Repeal safe-harbor leasing	3	4	6	7	8
Limit ACRS depreciation increase to 150-percent declining balance	—	—	3	14	19
Reduce ITC to 3⅓ percent for 3-year equipment and 6⅔ percent for 5-year equipment	2	4	6	8	10
Double existing excise taxes on alcohol, tobacco, telephones, and gasoline	10	12	13	14	14

Ms. RIVLIN. A number of other options are discussed in more detail in chapter XII of part III of our recently issued annual report entitled "Reducing the Federal Deficit." These include increased energy taxes and broad-based consumption taxes, such as a value added tax. A $5 per barrel fee on imported oil would raise as much as $17.5 billion a year, although some portion of that would be offset by lower corporate and individual income taxes. It would increase incentives for energy conservation and help to reduce U.S. dependence on foreign oil. A broad-based VAT could raise as much as $10 to $15 bil-

lion a year for each percentage point of the tax. If such a tax were substituted for part of the individual or corporate income tax, both of which impose a significant tax on savings, the overall burden of the tax system on savings would be reduced, thereby encouraging long-run investment and economic growth.

Another way of increasing revenues would be to reduce or eliminate some existing tax subsidies or tax expenditures. Those that create perverse or inefficient incentives should be examined especially closely. An example is the employer-paid portion of health insurance premiums which is now entirely exempt from taxation. Instead, premium costs above $150 per month could be included as taxable income in 1983 and indexed thereafter. Besides increasing Federal revenues by $2.6 billion in 1983 and about $8 billion in 1987, this option would be likely to narrow the scope of employer-provided health insurance, prompting people to economize on their use of medical care. Ultimately this could help curb health care costs.

Another possibility—and one that could raise still larger revenues—would be to terminate the deductibility of consumer interest payments. This deduction encourages consumers to buy on credit and discourages saving, particularly in times of high inflation. Ending this deduction would yield additional revenues of about $1.2 billion in 1983 and $9.6 billion in 1987.

CONCLUSION

In conclusion, Mr. Chairman, the prospect of chronic budget deficits long after the recovery is underway is a very serious problem. The increased interest rates resulting from such deficits are likely to crowd out private investment and limit long-run growth. The policy options available to improve the budget outlook and the economic outlook are not easy.

One option would be to encourage the Federal Reserve to adopt a more expansive monetary policy. This might result in a more vigorous recovery, particularly in sectors hard hit by tight credit conditions. Faster growth would also reduce the Federal deficit. But an easing of monetary policy, even moderately, might prolong the time required to achieve price stability and a highly expansionary monetary policy would virtually guarantee accelerating inflation.

A second option would be to enact further spending cuts and tax increases, or postpone tax cuts, to reduce the deficit. This would clearly reduce the conflict between monetary and fiscal policy and the amount of private investment crowded out. At the same time, however, it would require sacrifices on the part of many Americans that might be particularly onerous for those who have been adversely affected by the recession.

Thank you.

Mr. DOWNEY. Thank you, Dr. Rivlin, for your excellent, objective testimony as usual.

I would like to begin by asking you: When do you believe the economy will be out of the current recession?

Ms. RIVLIN. We believe that the recession will bottom out fairly soon and that growth will resume by summer. We expect the first half of the year, as is already evident, to be weak. There is still

evidence that the recession is continuing, but we would expect growth to resume in the summer and to strengthen as a result of the tax cut in July, so that the second half of the year is likely to be considerably better than the first.

Mr. DOWNEY. When do you expect employment to begin increasing?

Ms. RIVLIN. Unemployment?

Mr. DOWNEY. Yes.

Ms. RIVLIN. We think the unemployment rate may get a little worse before it gets better. That is a typical pattern. We would expect it to begin coming down in the second half of the year, but very slowly, because we do not expect the kind of vigorous growth rates that it takes to bring the unemployment rate down.

Mr. DOWNEY. Just 2 days ago Secretary Regan was before this committee and he indicated that there would be a new phenomenon known as "crowding in" as a result of the savings that would be generated as a result of the tax cut. The deficits which appear at least structural in nature at the present time would not be large enough to crowd out private investors and municipal governments that needed that money.

Could you give some assessment of what you think of crowding in, and if you could include in your testimony about what you think the deficits will mean in the out years, the recovery years?

Ms. RIVLIN. Frankly, I am more worried about the prospective deficits than Secretary Regan seems to be. We do think that there will be some increase in the savings rate after the next round of the tax cut, but not an enormous one, and deficits of the magnitude contemplated as the economy recovers would seem to us to require financing that would take up a very large proportion of the total credit available in the economy and risk crowding out private investment, especially in the face of continued tight monetary policy.

Mr. DOWNEY. With respect to interest rates, the administration is predicting that the velocity of money will be between 5 and 6 percent, a historic high. They also claim that during that period of time, interest rates will be going down.

My first question, No. 1 is whether that, in your opinion, is a prudent prediction; and No. 2, is there any historic precedent for that type of economic behavior?

Ms. RIVLIN. Our expectation is that interest rates will come down some in 1982. As the economy recovers in 1983, we expect that the short-term rates may go back up again a little bit before they begin coming down again. The administration is hopeful that they will not go up in 1983. We regard the administration's assumptions about velocity as being very much on the high side of historical experience. Partly for that reason, and since we have virtually the same expectation about nominal GNP, we think there will be somewhat more inflation and somewhat less real growth than the administration is assuming.

Mr. DOWNEY. I would like to turn just for a moment to the question of the safety net and to medicare, in particular. Who will likely bear the burden of reduced medicare reimbursement to hospitals and doctors? Will it be the hospital and the doctors? Or will the medicare recipients or other private payors?

Ms. RIVLIN. It is very hard to say, but it seems likely that the burden will be shared in part by the medicare recipients and in part by other people who use hospitals. This has been the tradition. In some cases, it will be fairly clear. Take the change in reimbursement for radiologists and hospital-based physicians, for instance. The proposed change there would clearly increase the out-of-pocket costs of medicare beneficiaries. In cases where this doesn't happen, it seems likely that part of the increased cost will be passed on to nonmedicare patients in the hospital. It is hard to break down exactly what will happen there.

Mr. DOWNEY. Let me ask you, with respect to the AFDC programs, and the three new provisions that the administration would like to see enacted: a mandatory job search, mandatory community work experience, and providing unemployed parent benefits only if the parent participates in workfare, do you believe that the savings that will accrue as a result of these requirements will cause these people to be able to go back to work, or cause them to become ineligible for AFDC?

Ms. RIVLIN. The administration, as we understand it, is calculating the savings on the assumption that fewer people will apply for AFDC because of these new requirements and not because of additional job seeking.

Let me ask Dr. Gordon if she will amplify on that. I didn't introduce my colleagues. Let me do that now. Nancy Gordon, on my right, is our Assistant Director for Human Resources, and James Verdier, on my left, is our Assistant Director for Tax Analysis.

Ms. GORDON. As Dr. Rivlin said, the administration assumes that all of the savings from their proposals would occur because people would be deterred from applying for benefits, not because by requiring that people seek jobs they would be able to find them in the economy. Certainly, given the current unemployment rates, one would expect it would be difficult for them to find jobs.

Mr. DOWNEY. Let me ask you one quick question about workfare. Has it been shown to be cost effective in the localities that have administered the program?

Ms. GORDON. There have been only some small demonstration projects and, unfortunately, the data that was collected from them is not yielding consistent results. My understanding, though, is that, in most of the demonstration projects, workfare has not proven to be cost effective—that is the costs of administering the programs have been greater than the savings from the reduced benefits. But I understand that there is one example where it was shown to be cost effective.

Mr. DOWNEY. Where was that?

Ms. GORDON. I believe that it was in San Diego.

Mr. DOWNEY. Mr. Russo will inquire.

Mr. RUSSO. Thank you very much, Mr. Chairman.

Ms. Rivlin, would you tell this committee what went wrong with the administration's program, why after the enactment of the President's budget cuts, the enactment of his tax cut, and his prediction that we would have higher productivity, greater savings, a lower deficit, lower unemployment, greater growth, and all the rosy scenarios that were brought before this committee in the last session, what went wrong with those assumptions?

Ms. RIVLIN. I think two things. The assumptions were very optimistic to begin with, in the view of the CBO and most other forecasters even a year ago. It seemed unlikely that interest rates would come plummeting down as the administration was assuming a year ago or that growth would be as rapid as they were expecting. However, it must be said that we were all wrong, that the CBO and other forecasters were also too optimistic and that we did not predict the sharp recession we are now in.

The decline in activity in the fourth quarter of 1981 continuing into this year was really not predicted. I think that was largely because monetary policy was tighter than anybody had assumed it would be and interest rates were even higher than we thought they would be. Finally, after not really reacting to high interest rates for quite a long time, the economy reacted in the way that traditionally one would have expected. The bottom fell out of housing and automobiles, and the rest of the economy slowed down drastically.

Mr. RUSSO. Dr. Rivlin, then what confidence do we have that your forecast or the administration's forecast of what is going to happen in the next 6 to 8 months is any more accurate than your forecasts of the last year?

Ms. RIVLIN. Well, you probably shouldn't ever have a lot of confidence in any economic forecasters. However, what both we and the Administration are projecting in the near term is that this will be a rather average recession for the postwar period. Recessions do end. They tend to bottom out after two or three quarters, and growth resumes.

The main reason for thinking that growth will resume is that we have already enacted, as you all know, a substantial tax cut beginning in July, which should strengthen the recovery. The forecast is unusually uncertain, however, because we have this peculiar situation of a stimulative fiscal policy, large deficits, and a very tight monetary policy.

We think the recovery will proceed, but I wouldn't bet on it.

Mr. RUSSO. I have heard the statement that the actual interest rate cost right now is the highest it has ever been in history. Is that a fact?

Ms. RIVLIN. Real interest rates, after adjusting for inflation, are extraordinarily high right now. I'm not sure whether you could find a period in history where they have been higher, but certainly there has been no such sustained period in recent memory.

Mr. RUSSO. Is there a reason for that high interest rate?

Ms. RIVLIN. The basic reason for high interest rates is the very slow growth of the money supply. A contributing factor has been the expectations of inflation, which certainly contribute to the sustained high long-term interest rates.

Mr. RUSSO. I yield to the gentleman from Georgia.

Mr. FOWLER. On that point, Dr. Rivlin, I read somewhere, and it may have been your report, that historically the curve of interest rates and inflation, whether it be up or down, that interest rates have usually been about 2 percentage points higher than the inflation rate. Regardless of whether we were in peaks and valleys, you had this relationship of 1½ to 2 points between the inflation rate and the interest rates, and now recently we have this extraordi-

nary phenomenon of interest rates being 10 points higher than inflation for the first time in history. What do you make of that?

Ms. RIVLIN. Well, as I was just saying, it is extraordinary. The chart that shows this——

Mr. FOWLER. Well, besides it being extraordinary, what do you make of it? Why is that?

Ms. RIVLIN. I think the two factors I just mentioned. The slow growth of the money supply has certainly precipitated the high rates. That has been a deliberate attempt to counter inflation, and it is beginning to work, but the price has been high interest rates. Also, the expectation that inflation will not come down rapidly has tended to keep the rates up.

Mr. RUSSO. May I reclaim my time for one last question? Dr. Rivlin, the administration claims that this deficit is a recession deficit partly due to the decrease in revenues resulting from a greater than expected drop in the inflation rate. What effect will indexing, which is designed to correct for inflation-caused increases in tax revenues, have on out-year deficits and economic assumptions based on future years.

Ms. RIVLIN. Let me say that the increase in the deficit in the current year is certainly recession related. As you look out ahead, however, the prospective deficits are independent of economic growth. The real problem now is that, with current policy or even with substantial deficit-reducing changes, we expect deficits to grow in the future, even in the face of recovery. Indexing of the individual income tax contributes. The growth in the deficit over the next 2 or 3 years, however, is primarily due to the rate cuts rather than to the indexing, which doesn't enter in until 1985.

What the indexing does is change the historic pattern of current policy forecasts, which would have given you declining deficits in the future. You don't get that now. The deficits continue.

Mr. RUSSO. And the deficit will be increased as a result of indexing unless the economy generates the revenues to make up for indexing?

Ms. RIVLIN. Indexing by itself doesn't increase the deficit; it just keeps it from declining, unless you have something to overcome that.

Mr. RUSSO. Thank you, Mr. Chairman.

Mr. DOWNEY. Mr. Duncan will inquire.

Mr. DUNCAN. Thank you, Mr. Chairman.

Dr. Rivlin, what are your projections for the savings rate, especially in light of the IRA liberalization in the 1981 Tax Act?

Ms. RIVLIN. We have a savings rate rising in the second half of this year. Let me see if we have the exact number on that. Let me supply that for the record.

[The information follows:]

The personal savings rate in the CBO forecast rises from about 5.3 percent in the first half of 1982 to about 6.6 percent in the second half of 1982, following the July tax cut. It then falls again to about 6 percent in the front half of 1983, as people adjust their spending to their higher disposable income. The July 1983 tax cut is also expected to bring an increase in the savings rate which is larger in the short run than in the long run.

Mr. DUNCAN. While you are finding that, what are your views on just a flat tax rate on all earned income?

Ms. RIVLIN. Oh, I think that is a fascinating reform that——

Mr. DUNCAN. Most things we do are fascinating.

Ms. RIVLIN. I think that the only way you could go to a flat tax without raising marginal tax rates for some people would be to broaden the base and to scrap the whole income tax. You would have to say we are going to start over and have just a flat tax on all income without substantial exclusions and deductions. And then you would have to bring the marginal tax rates down substantially. I think that would be well worth considering.

Mr. DUNCAN. Have you made a study of what that would do?

Ms. RIVLIN. Not recently. It would enable you to bring the marginal rates down very substantially, but to do that, of course, depends on broadening the base. If you just said we are going to have the same tax on everybody's income and raise the same amount of revenue, but we won't change the definition of income, you would have to raise tax rates for quite a lot of people.

Mr. CONABLE. Those at the lower end of the scale.

Ms. RIVLIN. Right.

Mr. CONABLE. Thrilling prospect.

Mr. DUNCAN. Do you have any answer to the question?

Ms. RIVLIN. I do not have it. I will supply it for the record:

[The information follows:]

According to the most recent Internal Revenue Service data, for calendar year 1980, a flat rate tax designed to yield the same revenue as the then-current system did, limited to the same tax base, would have required a rate of almost 24 percent. This assumes that the personal exemptions, zero bracket amounts, and itemized deductions were maintained at the same level.

Of course, whenever a tax system is substantially changed but constrained to yield the same total revenue, one person's tax cut is necessarily another person's tax increase. In this case, taxpayers in the lowest tax bracket (then 14 percent) would have had their taxes increased by over 70 percent (the flat 24 percent rate divided by the old 14 percent), while other taxpayers would fare increasingly better as their income increased.

Substantial tax cuts have since been enacted in the Economic Recovery Tax Act. When fully phased in, those cuts are equivalent to a 23 percent rate reduction across the board. This suggests that a lower flat tax rate could be imposed, slightly above 18 percent rather than slightly below 24 percent. However, there are complications. Our graduated tax rate system will profit from "bracket creep" between 1980 and 1984, when the ERTA rate cuts will be fully phased in. Therefore, the flat rate needed to collect the same yield as the graduated rates in 1984 will in fact be greater than the 18 percent suggested here. Second, the redistributive effects of the tax with the lower rate will be no less pronounced. Taxpayers in the bottom bracket in 1984 would pay a rate of 11 percent under ERTA, and so even an 18 percent flat rate would represent a 64 percent (the 18 percent rate divided by the 11 percent rate) tax increase.

The flat rate could be reduced by broadening the tax base. Including all of capital gains in gross income and taxing employer contributions to employee life and health insurance plans (plus some similar smaller items) would broaden the tax base and permit lower rates by about 10 percent (that is, a 2.4 percentage point reduction of the 24 percent rate). A further broadening would include the means-tested government transfer payments such as AFDC and food stamps; these programs involve large sums of money, but taxing them would raise little revenue because they are generally received by people with incomes below the taxing thresholds. A final broadening would be to tax Social Security, either when employer contributions were made or when benefits were received. This step would add substantially to the tax base, but it would be highly controversial. Also, with the Social Security trust funds running low, it might be argued that those trust funds rather than the general funds should have first claim on any new revenues generated.

Mr. DUNCAN. Thank you very much, Dr. Rivlin.

Thank you, Mr. Chairman.

Mr. DOWNEY. Thank you, Mr. Duncan.

Mr. Guarini will inquire.

Mr. GUARINI. Does CBO hold a position on the value-added tax as an alternative tax, an idea we have had hearings on in this committee in previous years?

Ms. RIVLIN. We never have a position on any tax or any other policy matter.

Mr. GUARINI. How would it work, though? You must have played with the figures and conceptually considered it.

Ms. RIVLIN. We have indeed, and it is one of the options offered in our thick document on "Reducing the Federal Deficit." The argument for a value-added tax is that it would be an additional source of revenue for the Federal Government that would enable you to shift the tax structure away from taxes on income which bear heavily on saving, and toward a tax on consumption.

There would seem to be a strong rationale for such a proposal in a period when we are trying to encourage investment and saving over time. It could be a fairly lucrative tax. We have estimated annual revenues of $10 billion to $15 billion for each percentage point of tax. One would not want to do that, presumably, on just a small basis. I think it is a sufficiently complicated tax to administer that you would probably want to consider shifting a major portion of the Federal revenue toward a value-added tax if you were going to do it at all.

Mr. GUARINI. In my limited time let me ask you this: the Senate is considering a constitutional amendment concerning balancing the budget. What comments would you have on that?

Ms. RIVLIN. I think we need to do something to induce the Congress and the administration to move toward a balanced budget. I am not an enthusiast of writing it into the Constitution, however, because I have never seen legislative language that I thought would be very helpful. One would have to write so many caveats into a constitutional amendment that I think it is just not a sensible way to achieve the goal.

Mr. GUARINI. In regard to the budget process, we go through this trauma every year with the budget resolutions and reconciliation, and Congress seems to spend more time doing that than administering the rest of the affairs of the country. Do you have any suggestion as to whether or not this should be done every 2 years or whether or not we should change our approach and our process?

Ms. RIVLIN. Yes. It seems to me that the time has come, for just the reasons you state, to consider seriously a longer run budget, presumably a biennial budget. The budget is taking an enormous amount of time and energy of the entire Government. If you could do it half as often, you might do it twice as well.

Mr. GUARINI. So you would be for attacking the program every 2 years?

Ms. RIVLIN. I think that would have some problems but it is a very attractive possibility.

Mr. GUARINI. Could you comment on delaying the $750 billion tax cut we will have over the next 5 years in order to balance the budget? Could you make some comments as to whether or not that would be appropriate and how it would affect our imbalance presently?

Ms. RIVLIN. One of the options to move toward a balanced budget, and probably the easiest legislatively, would be to delay the tax cuts already enacted.

Mr. GUARINI. I do not think it is the $4 billion here and $8 billion there that is going to balance the budget. If we are talking about $15 billion, it seems to me the only way to get at the issue is to get to the problem that caused our situation, and that big tax cut of averaging out over 5 years to $750 billion has to be the source of our problem.

Ms. RIVLIN. In my opinion, there is no single solution to this problem. If the Congress is going to ask what should we do, cut spending or increase taxes, I think the answer is both. It is a very big problem. Unless you raise revenues and cut spending, you will not solve the problem.

Mr. GUARINI. Do you believe in supply-side economics, that it will work if we hold the present course that we are on?

Ms. RIVLIN. That is not a question with a yes-or-no answer. I think it is very important to pay a lot of attention to the supply side of this economy, to encourage investment, which was the point of the corporate tax changes made last year, and to encourage saving. It is partly for that reason that I think it would be sensible to consider consumption taxes rather than a rescission of the entire tax cut.

Mr. GUARINI. Bottom line. You said that you feel that the crunch we are in now economically is a result of the money supply, that we have been too tight with the money supply, causing interest rates to go up. Is it your opinion that the Federal Reserve System has put too much emphasis on watching the interest rates instead of watching the money supply?

Ms. RIVLIN. No. They have been watching the money supply rather than the interest rates.

Mr. GUARINI. That is not what the Wall Street Journal said yesterday, and I am asking for your comment on it.

Ms. RIVLIN. No; I would not say that. I would say that they have been watching the money supply very carefully.

Mr. GUARINI. Thank you.

Mr. DOWNEY. Thank you, Mr. Guarini.

Mr. Shannon will inquire.

Mr. SHANNON. Thank you, Mr. Chairman.

Dr. Rivlin, would you be a little more specific about the deficits that you anticipate in the next few years?

Ms. RIVLIN. We have been very specific on what we anticipate in terms of a current policy deficit. That is, if you don't do anything, there will be rising deficits.

Mr. SHANNON. I guess what I am asking is what does your reestimate say?

Ms. RIVLIN. I cannot tell you that until tomorrow.

Mr. SHANNON. We will not tell anybody. We will just keep it in the room.

Ms. RIVLIN. Unfortunately, that information is for release at 11 o'clock tomorrow. I promised Chairman Hatfield that it won't be released until then, and there is nothing I can do about it.

Mr. SHANNON. Thank you very much, Dr. Rivlin.

Mr. DOWNEY. Mr. Conable will inquire.

Mr. CONABLE. Thank you, Mr. Chairman.

Dr. Rivlin, welcome before the committee. You always have an interesting diversion from the figures of OMB, and we always speculate as to which is which in terms of accuracy. You have generally had a pretty good track record. The administration's proposed budget, though, assumes substantial reductions in the growth of expenditures beyond those which would otherwise occur under current law.

Reductions total $56 billion in 1983, $84 billion in 1984, and $99 billion in 1985. On page 4 your table does not contain these assumed reductions, and obviously that is one reason why there is a divergence between your figures and the administration's.

I guess from that that you are indicating that you doubt Congress will enact these changes, or perhaps it is your policy to figure them only on current law, which is no impediment to the administration's doing it the way they want to. Am I correct in identifying that reason for some substantial divergence?

Ms. RIVLIN. We never make predictions about what the Congress will do. We answer two kinds of questions, essentially. One is what would be the deficit if policy is not changed? That question is answered in table 2. Our answer to that, it should be noted, is not very different from the administration's, at least in pattern. We are both saying that, if policy is not changed, the deficit will go up even in the face of recovery.

The second question we answer is what would be the effect of various spending cuts, including those proposed by the administration? We will reestimate the President's budget and we will be releasing that tomorrow. The numbers are slightly different.

Mr. CONABLE. I see. So that will show a different result.

Ms. RIVLIN. That is right.

Mr. CONABLE. Now, in answer to Mr. Russo, you talked some about the reasons for the diversions between the rate of inflation and the interest rates, which has become unhistoric at this point.

Ms. RIVLIN. Right.

Mr. CONABLE. You are talking primarily about long-term rates there, are you not?

Ms. RIVLIN. Both.

Mr. CONABLE. Well, it is true in even greater degree as to long-term rates than it is to short-term rates, isn't that right?

Ms. RIVLIN. That is right.

Mr. CONABLE. And in that case there is kind of a reverse effect in the monetary policy. If we were to have suddenly a great surge in monetary growth to try to accommodate the demand for money, wouldn't that have a tendency to at least over a reasonable period of time to put long-term interest rates higher because of the expectancy of inflation 6 months out and the need to protect the real value of loans?

Ms. RIVLIN. It is a very strange situation. Everything I learned in graduate school would have told me that increasing the money supply would give you lower interest rates. But we are not in that situation now because, as you say, we have this expectational effect. People believe that increasing the money supply will exacerbate inflation, and the long-term rates reflect that expectation.

Mr. CONABLE. Well, interest rates are a phenomenon that preys on the minds of Congressmen and appear rather prominently in the questions of their constituents when they go home. Is it possible to quantify the impact on interest rates, first of all, of the projected size of the deficit, including those projections which result from assuming that Congress will do nothing, second, the impact on interest rates of the cost of money when so much of our traditional lending institutions are receiving—are wholesaling their acquisition of money and going into very high interest paper like money markets, and so forth, and the impact of monetary policy itself, whether or not in response to expected deficits? Is it possible to quantify that at all or are we dealing in an area that is pretty soundly constructed of moonbeams here?

Ms. RIVLIN. I think there are a lot of moonbeams and it is very difficult to quantify. But I think the directions, especially on your first question, are clear. I would not hesitate to say that, if the rapidly escalating deficits which would result from the Congress doing nothing were to materialize, interest rates would go up. I think that is clear; they would go up rather than down.

Mr. CONABLE. Thank you.

Mr. DOWNEY. Thank you, Mr. Conable.

Mr. Heftel will inquire.

Mr. HEFTEL. Thank you, Mr. Chairman.

Dr. Rivlin, have you given any consideration to the role of the Federal Reserve and whether its independence is inconsistent with an attempt to remedy what is wrong with the economy at any point in time?

Ms. RIVLIN. The independence of the Federal Reserve is, of course, a legislative decision made by the Congress. You could change it. It does seem to me that the Federal Reserve is really doing about what everybody wanted it to do; namely, control the money supply to control inflation. Making the Federal Reserve less independent, more dependent on either congressional policy or administration policy might not change anything right now.

The thing that makes it very difficult for the Federal Reserve at the moment is that it is operating in an atmosphere of high prospective deficits. That puts a lot of pressure on monetary policy.

Mr. HEFTEL. Well, do you have any observations on how Congress can be expected to exercise the responsibility for reducing deficits? For instance, the Federal Reserve is trying to force us, let us say, to reduce the deficit, and they are maintaining the tight money and the high interest rates as a way in part to do that; but the result is a constant conflict. These two opposed positions are virtually self-defeating, as you can see from the economy today.

Do you have confidence in the Congress that it can or will control deficit spending to the point that you could have a less independent Federal Reserve?

Ms. RIVLIN. I actually have a lot of confidence in the Congress. That is why I am not an enthusiast of constitutional amendments and other mechanisms to put outside pressure on the Congress. It seems to me that discussions such as this one about the consequences of deficits and the options for changing them are the ones that will lead the Congress to action to reduce the deficit because the consequences are very serious if you do not act.

Mr. HEFTEL. You would, then, admonish the Congress to control the administration's proposed deficits?

Ms. RIVLIN. I think the important thing is for the Congress to work toward declining deficits in the face of recovery, not rising deficits.

Mr. HEFTEL. All right. If you do that but cannot control the money supply and interest rates, how can you predict a successful experience?

Ms. RIVLIN. I think there should be very close communication between the Federal Reserve and the administration and the Congress. You should communicate. You should require the Federal Reserve to talk very openly about what its economic targets are and what it expects to do, not day to day but in general, about the money supply. And you should communicate clearly what you expect to do about fiscal policy.

If you were to get into a situation in which you felt the Federal Reserve policy was really wrong, then you should consider options for changing it. That is, after all, within the power of the Congress.

Mr. HEFTEL. Do you think we can reach a point where Congress, the Federal Reserve, and the administration can sit down and plot a sensible economic program that looks at deficits, interest rates, and the supply of money?

Ms. RIVLIN. I should certainly hope so.

Mr. HEFTEL. Do you think we have done it so far? Do you see it happening?

Ms. RIVLIN. I don't think the Congress has done it so far but I think the Congress has made progress in communicating with the Federal Reserve and vice versa.

Mr. HEFTEL. Thank you.

Mr. DOWNEY. Mr. Pease will inquire.

Mr. PEASE. Thank you very much, Mr. Chairman.

Dr. Rivlin, it is a pleasure to have you and your colleagues and your accurate economic figures visit the committee. The latter category is a refreshing change, I might add.

I am interested in table 4-2 of your statement, which compares the CBO baseline figures for the next 5 years with the administration current services figure. You indicate that the administration current services figure includes proposed defense spending growth for the Defense Department. At what percentage would that be?

Ms. RIVLIN. It is about 9 percent real growth over the period from 1982 through 1985, and diminishing somewhat after that.

Mr. PEASE. And what percentage is included in the CBO baseline?

Ms. RIVLIN. Considerably less than that. What we did in the CBO baseline was to take the last actions of the Congress on the last round of appropriations on defense and cost those forward. What that gives you is about 3.5 percent real growth over the same period. So it is a lower real growth.

Mr. PEASE. If that is the case, then would it not be true that the figures on table 2 for outlays as projected by the CBO are really understated in comparison with the administration's figures?

Ms. RIVLIN. That is correct if you assume that the administration will get its defense program. There is one other difference that I might mention. We have put in our baseline the assumption that

discretionary programs not capped in reconciliation will grow at the inflation rate. They assume they will not grow at all.

Mr. PEASE. I see. As far as the defense assumptions are concerned, then, the projected deficits for CBO, if one assumed that the Reagan proposals for defense spending were to be enacted, the deficit figures would actually be higher than you show them here?

Ms. RIVLIN. Yes, very substantially. The administration's proposals would add about $70 billion by 1987.

Mr. PEASE. $70 billion. Thank you.

Second, Secretary Regan when he came before us the other day said that the current larger deficit for fiscal year 1982 is caused in part by the administration's success in bringing down the inflation rate. Do you happen to know what the projections were as of last year for inflation by the administration as compared with what the current projections are for fiscal year 1982 for inflation?

Ms. RIVLIN. The differences are not large. The difference is about 1 percentage point because the administration had fairly optimistic inflation estimates last year. I can produce that table for the record. But it is our view that the difference in the deficit is only in very small part related to the inflation change. It is in much larger part related to the much slower economic growth and higher unemployment.

Mr. PEASE. Well, yes. The administration is now predicting $99 billion for fiscal year 1982 as opposed to $43 billion 7 months ago, which is a substantial difference, $50 billion and some odd dollars. Can you give us even a wild ballpark estimate as to what part of that might be due to the difference in assumptions about inflation?

Ms. RIVLIN. Not very much—perhaps $2 billion. Most of it is due to economic growth.

Mr. PEASE. Now I would like to turn to some basic questions about differences between the OMB projections and the CBO projections for outlays in revenues and deficits over the next several years. In terms of the current services estimates, how much of the difference between CBO's figures and OMB's figures when related to the difference in economic assumptions which we have discussed, how much, if any, would be related to what you would consider to be unrealistic projections by the administration based on its own economic assumptions?

Ms. RIVLIN. I will give you a better answer to that tomorrow, but the answer is really both. The differences in budget numbers based on different economic assumptions between us and the administration, either with the President's proposed budget or with current services, are not enormous. A very large part of our differences are estimating differences or what we call technical estimating differences. An example of such a difference would be that we think the spend-out rate on defense programs already enacted will be substantially higher than the administration thinks.

Mr. DOWNEY. Mr. Frenzel will inquire.

Mr. FRENZEL. Thank you, Mr. Chairman.

Director Rivlin, thank you for your testimony. I am sorry I was not here to hear it presented. I have read through it, however. On page 1 of your testimony you indicate that the administration expects a relatively higher growth of GNP, of real GNP because they expect the deflater to fall to a rate of 5.5 percent.

Now, CBO expects the GNP deflater to rise by 1.5 percentage points more. That is a substantial difference in assumptions, is it not?

Ms. RIVLIN. No. We expect the GNP deflator to decelerate by about 1.5 percentage points less than the administration does.

Mr. FRENZEL. Well, your testimony doesn't say that. That helps me.

Ms. RIVLIN. Sorry about that.

Mr. FRENZEL. Over on page 3 you talk about growth of the economy and the predictions under the administration, and you have gone behind the historical patterns, I guess. Has there been as much incentive lying around available in our society in previous recoveries so that you feel restricted to follow the historical pattern?

Ms. RIVLIN. I think it is a compromise. It is true that the incentive to investment has been made very much more favorable by recent tax changes. That would be a positive factor. On the other hand, we have the counter factor, which is also without historical precedent—namely, the very high real interest rates. So that leads us back to saying that about the best we could expect would be real growth of average magnitude.

Mr. FRENZEL. OK. So you see higher incentives inhibited by——

Ms. RIVLIN. Inhibited by the high interest rates, yes.

Mr. FRENZEL. Thank you for clearing that up for me.

On page 9 you talk about cutting into defense spending, and you give some examples of restricting defense spending to a percentage of real growth.

Ms. RIVLIN. Right.

Mr. FRENZEL. I think they are interesting tables. I suspect they are unreal in that it is going to be very difficult for us to cut defense spending in the close-in years and relatively more easy to cut it in the out years unless we want to get into employees or operations and maintenance. I suspect most people when they think about cutting defense are talking about systems. If you cut a system, you are not doing much in 1983 and perhaps not very much in 1984; is that correct?

Ms. RIVLIN. You are absolutely right. Those illustrative numbers were arrived at quite simply. What we did was exempt pay and then cut everything else proportionately. That means that you would be taking fairly deep cuts in operations and maintenance. If you do not want to do that, if you wanted to cut only procurement, then you would get much slower outlay effects.

Mr. FRENZEL. Thank you.

On page 12 you talk about using something other than the CPI as an escalator, and you give us some examples of delaying COLA's, skipping them, reducing them, taking two-thirds of them, et cetera. It has also been suggested that you tie them to CPI, a percentage thereof, or increase in wages, whichever is lower.

How would a system like that work out, say, for the coming fiscal year? Do you suspect that the increase in wages will be lower than the CPI or higher?

Ms. RIVLIN. No, we expect a real increase in wages, so that this change would not save money. It might save money in the Federal retirement programs. If you were to limit that indexing system to

the Federal pay raise, you might save some money there. But for wages in general, although the idea is an attractive one, it seems unlikely to save any money in the next year.

Mr. FRENZEL. Thank you.

On page 15 you talk about consumer credit interest deductions, developing $1.2 billion in 1983. We always looked at an annualized figure of $6 billion. Does this reflect a partial, bringing it in to the fiscal year in only a part of the fiscal year?

Ms. RIVLIN. Let me ask Mr. Verdier to answer that one.

Mr. VERDIER. There are a couple of things going on. The number is small for 1983 because we assume that the change goes into effect on January 1, 1983, so only a small portion of the full-year effect shows up in fiscal year 1983. There also have been some changes since the calculation you mentioned was made, both in the interest rates that are assumed and in technical estimates of what exactly consumer interest entails.

Mr. FRENZEL. I assume that that means, that low figure means that you don't think we are going to sell a lot of cars in the next couple of years? That is what worries me about your figure.

Mr. VERDIER. Let me give you a more representative estimate of a full-year effect from our report.

Mr. FRENZEL. Maybe you should give it for the record since I see I am imposing on my colleagues.

Mr. VERDIER. Fine. A more representative example is the full-year effect of that change in fiscal year 1984, which is $7.8 billion.

Mr. FRENZEL. A little more reassuring. Thank you.

Mr. DOWNEY. Mr. Bailey will inquire.

Mr. BAILEY. Thank you, Mr. Chairman.

Dr. Rivlin, Mr. Volcker was here and pinpointed in his opinion that inflation is our major problem today, still the major problem, the major fear at least that he has. And in our discussion I brought in my major concern. It is productivity increases as something which is at the root of many of our problems. I think we all agree with that.

I noticed on page 9, and I will quote from your statement:

> Nearly 75 percent of the increases during 1983 to 1985 would come in corporate income taxes, offsetting about 60 percent of the corporate tax reduction enacted in the Economic Recovery Tax Act for that period. No proposals were made in the February budget to delay or eliminate any of the scheduled rate reductions in individual income taxes that were also enacted in ERTA.

Now, you seem to imply that perhaps—and I do not want to be unfair to you—that you have some preference for some more consumption-oriented tax than you would income taxes, because of the impact on savings. By the same token, given our present tax structure today, do you have any recommendations about the revenue side of dealing with this deficit problem which appears to concern you, and rightfully concerns all of us?

Do you think that, in other words, the administration's proposals on corporate taxes should perhaps be tempered or mixed with some type of recommendation on the personal tax side?

Ms. RIVLIN. That clearly is a question for the Congress to decide.

Mr. BAILEY. I realize that, but I am curious about your opinion.

Ms. RIVLIN. I think there are really two questions. One is what could you do quickly, and the other is how should you be shaping

Federal tax policy over the longer run. Over the longer run, it would seem to me that you ought to give very serious consideration to moving toward consumption taxes. That need not be a value added tax. There are other possibilities.

Mr. BAILEY. My question was, given the tax structure we have today, though, and given the alternatives that you have pointed out here, what do you think should be done or what recommendation would you give us?

Ms. RIVLIN. We do not make recommendations. I do think you should consider both the corporate and the personal side.

Mr. BAILEY. That is good. Thank you very much.

Have you done any work at all on the percent of gross national product that would be affected or involved, assuming a hypothetical where the New Federalism would take place, assuming President Reagan were able to shift essentially from a Federal tax base to State and local tax base responsibilities for Federal programs? Assuming those programs would maintain the same kind of vitality, with minor changes naturally, and after block grant reductions already in effect have been accounted for, what is the impact on gross national product?

If you have not done that work, would you do so? What percent of gross national product would governments of all types then take?

Ms. RIVLIN. We could certainly look at that. I do not see why it would change if you are just shifting programs from the Federal Government to the State level. On your assumptions as given in the question, I do not see why there would be any change in the impact on gross national product.

Mr. BAILEY. Well, I do not think it would either, but I am wondering if you could look at it, and I would be very curious to have your answer.

Mr. Volcker referred to crowding. You have referred to crowding. I am talking about the pressure on the credit pool, the Nation's credit pool. Can you quantify that for us at all? You know, how much crowding? Where does this thing start to ease up, ease the pressure on interest rates?

I mean, do we have to send a psychological signal about that deficit that is very firm in order to do that, or is it a mechanical kind of a thing?

Ms. RIVLIN. It is not mechanical. There is just no good way to quantify it. I think it comes down to the need to send a signal.

Mr. BAILEY. So the important thing for us to do is do something with policy in terms of deficit, combination spending and revenue to send a very, very strong signal, and that would have an impact, but the mechanical approaches via monetary or fiscal policy alone probably will not have a sufficient effect in your opinion?

Ms. RIVLIN. I would agree with that.

Mr. BAILEY. One last question, two really. The $109 billion deficit that you referred to—quite frankly, from my very inexpert position, that appears to be a relatively conservative figure that I would think you are going to have to revise upward. I hope that is not encroaching on your promise to the Senators or whatever. If it is not, I would like you to comment. I would just view that $109 billion estimate as somewhat conservative.

Second, I would like to compliment you on the figures you used on leasing. I have some problems with the leasing thing myself, although you may be aware of some of the amendments I have worked on here to try to reindustrialize or get some money back to our capital-intensive industry.

But you at least took the figures which would take into account the existence of ITC's and deductions and separated from that the impact of leasing itself, and ended up with lower figures than some of the outlandishly high figures that have very incorrectly been put forward and presented to the public. Those figures have generally not taken into account the fact that the major percentage of investment tax credit load carried by corporations that earn them would be burnt up if the carryforward rules and the kind of tax liability that they would earn would still apply.

I want to compliment you on that, because it's one of the most unfortunate distortions that we have had to encounter. And I thank you very much for your appearance here.

Mr. DOWNEY. Thank you, Mr. Bailey.

Mr. Anthony will inquire.

Mr. ANTHONY. Thank you, Mr. Chairman.

Dr. Rivlin, welcome before the committee. I just have three quick questions. One; what, in your opinion, is the wisdom of the Federal Government engaging in financing of its debt over a long period of time, that is, 30 years, when we are faced with historic high interest rates?

Ms. RIVLIN. Well, I do not think you would want to move entirely to short-term debt.

Mr. ANTHONY. Is that not what the corporate sector is doing, moving to short-term debt?

Ms. RIVLIN. They certainly have moved somewhat in that direction.

Mr. ANTHONY. Fairly substantially in the last 2 years?

Ms. RIVLIN. Yes. I am not an expert on debt management. You might ask the Secretary of the Treasury that one. But I would think it would not be sensible to get yourself into a situation where you were entirely into short-term debt.

Mr. ANTHONY. It would be unmanageable?

Ms. RIVLIN. It would be difficult.

Mr. ANTHONY. Very difficult.

Ms. RIVLIN. Yes.

Mr. ANTHONY. Last year I know we had an awful difficult problem, not only in the Congress, but as we went back home trying to talk to our constituents, mainly because everyone was talking from a different set of numbers, different baseline figures, and as a result there was just total chaos, total confusion. We get on the House floor for a debate and somebody would make a speech and they would be correct because they would be using their assumptions and their baseline figure, and someone would get up right behind them and challenge them, and they would be correct because they would be using their own baseline figures and their assumptions. But there would be wide differences between the two.

For a disinterested person other than that they just wanted something done to cut spending, hold down taxes and balance the budget, it was terribly confusing.

Do you see any hope in the debate in 1982 that we could come up with a better defined common baseline figure before we get into the heated debate?

Ms. RIVLIN. I hope so. I certainly agree that the situation was chaotic last year and very difficult for anybody to understand. I think it will be better this year. One reason is that the economic assumptions of the CBO and the administration, are closer this year. The administration is not as optimistic about the future relative to us as it was this time last year. That should reduce the difference. We will certainly help to the extent we can to explain things on both bases.

It has been suggested that maybe a common set of assumptions could be arrived at. I do not see any institutional way of doing that. An administration really has to put its best foot forward, and the Congress has to have an independent view. Those will not be the same.

Mr. ANTHONY. And it is still just going to continue to be our obligation, then, to differentiate between the two sets of numbers and try to educate not only ourselves, but our public?

Ms. RIVLIN. I am afraid so.

Mr. ANTHONY. But as I understand you, you say you are willing to do your part to try to help to educate us as between the difference between your numbers and the administration's numbers?

Ms. RIVLIN. That is correct. And I am interested to see that Mr. Stockman is also doing the same thing. He is showing very frequently in the charts he uses in his testimony both sets of figures on the same table.

Mr. ANTHONY. That is good. I know it was terribly confusing last year.

The last question may not have an answer, but it is something that seems to be getting an awful lot of attention right now, and you have done it in your testimony before the Budget Committee and again before this committee. That is, eliminate certain consumptive tax deductions, that is interest deductions for consumer loans.

I just wonder if you could speculate what the overall impact would be, the effect on interest rates, if we took away all interest deductions. Now, like in my case, I came to Washington, D.C. I bought a much more expensive house than I ever would have bought back in Eldorado, Ark. But I did so because I can deduct the interest. And I know a lot of people do the same thing. You buy an automobile, a washing machine, a lot of other things, and you deduct the interest.

I just wonder what the effect would be in the marketplace if you could not write that off against your income tax. Would you care to speculate on that?

Ms. RIVLIN. Presumably, there would be less borrowing and some downward pressure on interest rates. It would be hard to say how much.

Mr. ANTHONY. Thank you.

Mr. DOWNEY. Mr. Moore will inquire.

Mr. MOORE. No; thank you.

Mr. DOWNEY. OK.

Mr. Stark will inquire.

Mr. STARK. I have no questions.

Mr. DOWNEY. Mr. Pease, do you have additional questions?

Mr. PEASE. Thank you very much, Mr. Chairman.

Ms. Rivlin, I would like to pursue my understanding of the differences again between CBO estimates and OMB estimates. You have not at least thus far, and maybe you will have tomorrow, compared or commented on your view of the President's 1983 program for spending cuts and revenue enhancements. Will you be doing that tomorrow?

Ms. RIVLIN. We will do that tomorrow, and we will have a set of reestimates of those numbers.

Mr. PEASE. Could you state just in general whether you have come to the conclusion that the spending cuts and revenue enhancement figures are realistic in terms of the proposals made?

Ms. RIVLIN. We differ in some respects from the administration, as we always do. We generally find that outlays are underestimated. But I cannot give you the details right now.

Mr. PEASE. OK. On page 9 of your statement, I was very interested to read that: "Nearly 75 percent of the increases"—and this is relevant to the President's revenue package—"during 1982 to 1985 would come in corporate income taxes, offsetting about 60 percent of the corporate tax reduction enacted last year."

Ms. RIVLIN. I was surprised at that, too. It is quite a large offset.

Mr. PEASE. Do you think that enactment of those proposals by the President might have seriously inhibiting effect on recovery? If the original recovery were premised on the tax cuts, would not this have the opposite effect?

Ms. RIVLIN. I think you should examine them very carefully from that point of view. But it should be remembered that it is not a large amount of money and that it is the personal income tax reductions that are in large part being counted on to enhance the recovery.

Mr. PEASE. Well, the large personal tax cuts impact more on the deficits than the corporate tax cuts. But I think we were told last year by the supply siders that psychologically the cut in business corporate taxes would be very important in reigniting the economy.

Would not this proposal work counter to that?

Ms. RIVLIN. I think it might, and I think you should encourage expert testimony on the individual pieces of the proposal when you get them. It is not yet clear exactly what they are.

Mr. PEASE. Going back to page 2, table 1 of your testimony, you project from CBO that the Consumer Price Index will decline year by year to 4.5 percent in 1987.

Ms. RIVLIN. That is the administration's assumption. Our assumption is not quite as optimistic as that.

Mr. PEASE. I am sorry. Yours is 5.7 percent. OK.

Ms. RIVLIN. Right.

Mr. PEASE. Do you think that even your 5.7 percent is realistic in terms of the very large budget deficits that you also project?

Ms. RIVLIN. I think that the large budget deficits that we project on a current policy basis, or even anything approaching them, would threaten either the decline in inflation or the growth rate or both. If we do have escalating deficits over the next few years, there is a substantial risk that the recovery would be aborted. If

the Federal Reserve were to loosen up monetary policy in order to avoid that, then there would be the risk of higher inflation rates.

Mr. PEASE. Recognizing that projections out 5 years are very difficult, I am fascinated as to how you go about it. You have predicted under your current services budget a deficit, as I recall, of $248 billion in 1987. Does your projection that CPI will come down to 5.7 percent for that same year assume a $248 billion deficit, or does it assume some action by Congress to ameliorate that large deficit?

Ms. RIVLIN. CBO's 5-year economic and budget projections include a short-range forecast covering a 2-year period, and then longer range assumptions about the next 3 years. Those longer range assumptions are not forecasts of probable economic conditions but are, instead, projections that assume what appears to be an attainable improvement in economic conditions. We project out what continued rates of growth and consistent declines in inflation would give you, and then translate those into budget numbers. So I would not claim, indeed I do not believe, that deficits of that magnitude by 1987 are really consistent with continued growth.

Mr. PEASE. Thank you.

Mr. DOWNEY. Mr. Bailey will inquire.

Mr. BAILEY. Thank you, Mr. Chairman.

Dr. Rivlin, going back to the questions that I was asking before and picking up on the first part of the questions just asked by Mr. Pease, there is a relationship, of course, between the impact of a personal income tax, and the beneficial effect of a tax system that taxed consumables more, given our present problems. Obviously we know there is a relationship there.

It might not be as beneficial as we would like ideally, but nonetheless there is. On the other hand, as far as the corporate rate reductions and/or leasing types of approaches, investment tax credits and deductions and those types of things, what we have tried to do, because of our sensitivity to that word "productivity" again, is of course to, in a sense, target those cuts, preferably at reinvestment sectors in the business community, with an eye to and an appreciation of the pressure on capital that I think has been a distorted aspect of our tax structure.

Now, taking all that gobbledy-gook into account, would you say that productivity is a problem, that the recommendations on those corporate tax cuts that you mentioned are unproductive, at least in terms of their impact on reinvestment? You are right, they are small in numbers, but they are very targeted at reinvestment incentives.

Would you say they would have a beneficial impact on productivity or a negative impact on productivity? It should be an easy answer, obviously. But I am curious if you would comment?

Ms. RIVLIN. I think that the basic thrust of the corporate tax changes was clearly to make return on investment after tax higher—it had been eroded by inflation. Those changes were needed and will encourage investment and encourage productivity.

Whether you gave exactly the right incentives sector by sector is not clear, and if not, how to fix it is not clear. But the basic thrust was pro-productivity.

Mr. BAILEY. Your response exceeded my wildest expectations.

Let me now go back to the first question that I had asked, about the impact on consumables of that personal income tax and what many people would prefer, some sort of value-added tax or some more direct relationship between the taxing nexus that puts the pressure on consumables and that word, productivity. In terms of what this economy needs, do you not reach the inescapable conclusion that the recommendation that the administration is making should rather go then to the personal income tax area, because the recommendations in the corporate area do not make good productivity sense and if you do not make good productivity sense you do not make good anti-inflation sense?

Is that a fair statement?

Ms. RIVLIN. The last part of it is certainly clear. We need to encourage productivity. There are lots of other things to balance with that, however. For example, if you were to rescind the July personal income tax cut, I think you would have to worry a lot about what that would do to the recovery.

Mr. BAILEY. Excluding the top marginal rate or excluding changes in effective tax rates on capital, does that make sense, to back off on the personal income tax cut?

Ms. RIVLIN. I am not sure. I think that backing off on all of the tax cut would probably slow down the recovery.

Mr. BAILEY. It also would not make good productivity sense in your opinion?

Ms. RIVLIN. There are a lot of things that govern productivity, and you do not get investment unless you get a recovering economy.

Mr. BAILEY. And you would think that the human equation, using a very broad definition of the word "productivity" in all fairness to the administration, that the deficit equation would have a very important impact on investment preferences and business deferment decisions and those kinds of things, too? I want to be fair to the other side.

So you think that the deficit is a very important part of it, but you are not too excited about these corporate tax changes?

Ms. RIVLIN. That is right. I do think the deficit is very important, but I think that the personal income tax cut enhances the chance of coming out of this recession. So I would be wary of rescinding it all.

Mr. BAILEY. I just do not know how many choices we have. You know, we all have druthers.

Ms. RIVLIN. You do not have any good ones.

Mr. BAILEY. That is right, we do not, and I would say that getting out of the hypothetical into the real, that making the hard choice perhaps we ought to look at the personal side, and that the corporate thing, as politically appealing as it is, does not make good productivity sense. It is absolutely counterproductive, in my opinion.

Thank you very much.

Thank you, Mr. Chairman.

Mr. DOWNEY. Thank you, Mr. Bailey.

Ms. Rivlin, I have a series of questions that I would like to ask you, and if you could respond briefly to them.

In terms of economic growth, unemployment rates, interest rates and inflation, if you could be brief in the answers, what is the difference between current policy and the administration's program?

Ms. RIVLIN. In terms of what?

Mr. DOWNEY. Employment rates, interest rates, and inflation. What is the difference between current policy, without changes in law and the administration's program?

Ms. RIVLIN. The administration's program does act to get the deficits down, relative to current policy. It seems to me that that is the direction one should go if one wants to enhance growth and ultimately to bring inflation down.

Mr. DOWNEY. What is the difference between the administration programs and Senator Hollings' proposals?

Ms. RIVLIN. Senator Hollings' proposals would bring the deficit down more than the President's would. I think it is very hard to say exactly what the economic effect of the Senator's proposals would be. What you have to do is balance the stimulative effect of the deficit in the near term against the longer run harm of higher interest rates and lower productivity.

Mr. DOWNEY. Regarding the unemployment rate and the deficit, we hear numbers bandied about. I would like to get this on the record. For every percentage of unemployment for fiscal year 1983, what is the potential tax revenue loss to the Government?

Ms. RIVLIN. Tax revenue loss for each percentage point of higher unemployment is around $16 billion in the near term, growing somewhat if unemployment is sustained. On the spending side you add about $9 billion. So it is about a $25 billion difference in the deficit for each percentage point.

Mr. DOWNEY. Did you break out the $9 billion on the spending? Part of that is unemployment.

Ms. RIVLIN. Most of it is unemployment compensation. Part of it is welfare, AFDC. We can give you that for the record.

Mr. DOWNEY. Before you do that, can you give me a percent? Is it 75 percent unemployment and 25 percent AFDC? I mean can you give it to me roughly?

Ms. RIVLIN. It is mostly unemployment, so I think that about 75 percent is a fairly rough estimate.

Mr. DOWNEY. Can you give me your view of the management initiatives outlined in the President's budget this year? Perhaps we could run through several of them and you could critique them, starting first with the estimated receipts of the offshore oil leases. Is the savings from the revenue that the administration hopes to get from that realistic, in your opinion?

Ms. RIVLIN. We regard those as very optimistic and we have lower estimates of the OCS receipts.

Mr. DOWNEY. How much lower?

Ms. RIVLIN. Around $5 billion per year.

Mr. DOWNEY. So that would be fully $3 billion less than their estimate, is that correct?

Ms. RIVLIN. I think it is about a $5 billion difference.

Mr. DOWNEY. A $5 billion difference. Then what about some of the revenue to be gained by the addition of 5,000 revenue agents for the Internal Revenue Service? Do you anticipate that they will

be able to garner as much revenue as the administration predicts they will?

Ms. RIVLIN. I don't know exactly what our estimate is on that.

Mr. DOWNEY. Could you supply that for us?

Ms. RIVLIN. I will turn that one to Mr. Verdier.

Mr. DOWNEY. Thank you.

Mr. VERDIER. We don't have full details on that yet. The Internal Revenue Service's budget documents, however, indicate that if they are assuming about $13 in increased revenues from every $1 they spend on additional staff and resources. That is substantially higher than the $4 for every $1 of increased expenditures we have conventionally assumed.

However, the IRS is going to have these extra agents do things that could very well bring in a substantial return—for example, to go after delinquent accounts. So that $13 may in fact turn out to be a plausible number.

Mr. DOWNEY. Would that $13 ratio of return for every $1 of expenditure be realistic?

Mr. VERDIER. We would have to see the details, but as I say, it does look like it is a higher ratio than we have normally assumed.

Mr. DOWNEY. Dr. Rivlin, I want to ask your Human Services person a little bit about the AFDC proposals. Last year in the Reconciliation Act, the marginal tax rates for AFDC families were increased significantly. For example, a mother and two children in Pennsylvania, taking into account AFDC, food stamps and the insurance value of medicaid, earned about $400 a month, a gain of about $103 over a mother who does not work.

Now, with the changes enacted in Reconciliation, this same mother actually loses $63. What effect do you think that the changes will have on encouraging AFDC recipients to take jobs?

Ms. GORDON. I think that this is a very difficult area because one has to try to figure out how people will behave if they are essentially in the same financial position whether or not they hold a job. I think it is reasonable to suspect that especially people who don't have jobs or who lose their jobs would be less energetic about looking for another job. Some might even actually quit a job that they held.

CBO has based its estimates of the savings from that change in the law by assuming that about a third of the 190,000 families that are in the position of having essentially the same financial resources available to them whether or not they work will, in fact, no longer hold jobs. So we are saying that for about a third of them, there will be a change, and for about two-thirds there will not.

Mr. DOWNEY. Thank you.

Ms. Rivlin, I want to read you a passage from the economic report of the President, and I do not want to just be accused of quoting out of context. It comes from the general subtitle of "Strengthening the Federal System," and I just want your reaction to this paragraph. "One reason or the revised division of labor"—and by that they mean giving more to the States and localities—"is the basic tenet of the administration that income redistribution is not a compelling justification in the 1980's for Federal taxing and spending programs."

It is the administration's view that the Federal Government can do more to provide lasting assistance to the disadvantaged by assuring strong and less inflationary economic growth than through income transfer programs.

Would you consider the social security system an income transfer program, Ms. Rivlin?

Ms. RIVLIN. It depends on your definition of income transfer. It is certainly a transfer from those who are working to those who have retired. That is the way we have set it up.

Mr. DOWNEY. I am not setting you up for anything. Please do not feel defensive. If I retired at age 65 in 1972 and I had been earning the midrange amount and I had been retired since 1972, this is 10 years later, is it not true that the amount of money I paid into that system if I live now to age 80 is going to be more than made up to me in retirement benefits? Is that correct?

Ms. RIVLIN. Yes.

Mr. DOWNEY. More than made up, maybe by twice or three times?

Ms. RIVLIN. That is right.

Mr. DOWNEY. Is that not an income transfer program?

Ms. RIVLIN. It is an income transfer program, and we have chosen to set it up that way, not as a strict insurance program but as a pay-as-you-go transfer program from those who are working to those who are retired.

Mr. DOWNEY. I'm going to quote from the President's 1982 Economic Report: "Income redistribution is not a compelling justification in the eighties for Federal taxing and spending proposals." What conclusion would you make from that sentence? What inferences would you draw about social security retirement benefits, SSI, AFDC, medicaid from that sentence? What does that tell you?

Ms. RIVLIN. It is really very hard to say. It is clear from looking at the budget document itself that the administration is cutting back differentially on transfer programs and especially on means-tested transfer programs. There is no doubt about that.

Mr. DOWNEY. And they expect people to find, that these people who have these means-tested programs who will be losing benefits, are likely to find employment in private industry. Is that the logical conclusion? It certainly appears here to be the logical conclusion. Is that the inference you draw from this administration's proposal?

Ms. RIVLIN. I would certainly draw from the passage quoted that the administration wants to put major emphasis on finding a way to get the economy stimulated and deemphasize transfer programs.

Mr. ANTHONY. Would the chairman yield?

Mr. DOWNEY. I would be happy to yield.

Mr. ANTHONY. I think the chairman was really zeroing in on a very interesting point and, I think, a very worthwhile point, and a point that I think needs to be made and stressed adequately because it goes to the point of fairness, and fairness, Mr. Chairman, is something I have been hearing a great deal about as I go back home.

On page 10 of Dr. Rivlin's testimony, I think she has really set it out in very explicit and graphic and dramatic terms, and if you really do a little simple math, you find out that the proposal takes

60 percent of the cuts out of 18 percent of the entitlement programs, 30 percent of the cuts out of 67 percent of the entitlement programs. I think that is pretty dramatic. So the illustration that you are making I think is one that needs to be made for the record and one that I think needs to be very sharply debated as we go along massaging the numbers.

Mr. DOWNEY. I thank the gentleman for pointing that out. That was to be my next question and certainly should be one that we should address to Secretary Schweiker whose responsibility it is to make sure that people are not hurt. I am concerned that you point out in your testimony, do you not, Ms. Rivlin, that in terms of saving money, that the social security and COLA are broader based programs and potentially larger areas to save money, and it is politically particularly volatile and problematic?

Ms. RIVLIN. That is just a fact. The social security program is very much larger than the others. The retirement programs in general are larger than the means-tested programs. They involve a large number of recipients over which to spread any given cut.

Mr. DOWNEY. Are there any other members of the full committee who wish to question Dr. Rivlin?

[No response.]

Mr. DOWNEY. If not, the committee thanks you for your testimony. Thank you very much, Dr. Rivlin.

Ms. RIVLIN. Thank you. If there is anything else we can do for you, please let us know.

Mr. GUARINI. Just balance the budget.

Mr. DOWNEY. The committee is pleased to welcome the Secretary of Health and Human Services, Richard Schweiker.

Before you begin, Mr. Schweiker, I have a brief opening statement and it concerns the basic fairness of the administration's proposed cuts. We learned just in testimony prior to your appearance, from the Director of the Congressional Budget Office, that means-tested programs, which are directed toward low income persons, including many elderly persons, account for 18 percent of all of the outlays for payments to individuals. We have further learned that over 60 percent of the cuts would affect such means-tested programs, including food stamps, medicaid, AFDC, and that 30 percent of the cuts would be in non means-tested programs.

The Ways and Means Committee, as you know, is responsible for AFDC authorization as well as medicare, low income energy assistance, and I, for one, view with alarm the basic inherent unfairness that I believe is in this budget.

Mr. Conable, do you have an opening statement?

Mr. CONABLE. Well, I appreciate the chairman's statement. I think the Secretary is quite capable of going through the reasons why we have had to cut where we have had to cut here. You are not going to cut back on the size of Government without cutting programs, and unfortunately, most programs are addressed to people who cannot look out for themselves, or at least in the expected pattern that has developed over the years.

We have created dependencies and we have come to question whether those dependencies are in the long run in the best interest of the beneficiaries. I do believe that to assume that to cut back on any of these programs is inevitably going to be to the long-term

detriment of the beneficiaries is to accept a role of Government that I don't believe the American people are willing to accept in the long run.

Well, I will let the Secretary speak for himself. I want him to know, though, that we all deeply regret the pressures that are on the Government now and assume that we have an obligation to deal with them in some way.

Mr. DOWNEY. Thank you.

Mr. Secretary.

STATEMENT OF HON. RICHARD S. SCHWEIKER, SECRETARY OF HEALTH AND HUMAN SERVICES

Secretary SCHWEIKER. Thank you, Mr. Chairman and Congressman Conable and members of the committee. I appreciate the opportunity to appear today before the House Committee on Ways and Means to discuss relevant portions of the President's budget for fiscal year 1983.

The budget we present for fiscal year 1983 builds upon the new course we began last year. It is based on helping those most in need, a new partnership with the States, fiscal responsibility, reform of our entitlement program, and regulatory relief. We will maintain our leadership role in health research and disease prevention and control. We will confront the hard facts of health care cost inflation.

Mr. Chairman, I realize we have a time factor so I am going to put the bulk of my statement in the record, but I would like to look at a few charts first and then just read a very short summary of my full statement.

Over my right shoulder here are a list of what I believe are the accomplishments in my department during the first year. I think that item 1—and I might say these charts are in my testimony, so if some of the members' angle is not too good, they can see them from the statement—is the fact that we have established a new national health agenda.

I happened to put wellness at the top of that agenda. Along with wellness comes the fact that we have maintained the research facility at NIH, which proudly has some 52 Nobel prize winners there and I think is probably our best investment in biomedical research in the world.

Second, we have set up a task force with the medical schools to bring together more curriculum emphasis on health promotion and wellness as opposed to just disease control. Third, we have launched a public education program about wellness and the effect of wellness in many respects. We have launched a sodium initiative to label sodium products for hypertension prone people as well as a private sector program to encourage companies to do what some 500 or 600 of them are now doing, which is to invest in wellness as a way of eliminating absenteeism and improving the health and vigor of their employees.

Next on the agenda and equal to it is the consumer choice and competition proposals. We have task force recommendations that will be acted on very shortly that propose three basic things. One is a range of choices for employees to choose programs in terms of

health insurance that will be more cost efficient and that will reward the employee for choosing a lower cost option by some kind of a rebate to the employee.

Second, we are going to be talking about vouchers for medicare choices so that we may enter the element of competition and bring HMOs and other cost-effective ways of delivering health services more into our medicare reimbursement system. And third, medicare cost sharing catastrophic coverage.

We are looking at a proposal that would include protecting our medicare people who after 60 days go off the medicare rolls with some kind of catastrophic health protection for those whose problems do not stop after 60 days.

We also are working in the field of deregulation in terms of block grants to the States phasing out the health planning and starting to close the drug lag. We had some 27 new chemical entities approved at FDA, which set a new record, the highest since the drug law of 1965 was passed, and I have a task force that is expediting approving drug applications that is about to report to me next month.

We have saved about some $2 billion in the waste, fraud and abuse program that we initiated for the current year, and we have also, I might say, successfully done something that the last six administrations have tried to do, which is transfer public health service hospitals and clinics to the private sector. I am rather proud of this because of the fact that we did not shut them down, we transferred them to the private sector.

Seattle, Baltimore, and New York are all using them as community hospitals. Louisiana is using it as a children's specialty hospital. The fact that we were able to spin them back to the private sector and utilize them I think is a real accomplishment and one that I think we can be proud of in terms of keeping the private sector involved in them.

We have targeted welfare benefits. We have reduced the size and cost in my own department. My employment of 150,000 employees was dropped by about 7 percent. Now, some of those were reemployed in the private sector vis-a-vis the Public Health Service hospitals, so it is not a direct layoff effect by any means.

In addition, we have also cut our own travel expenses some 20 percent, which I know this committee has had some interest in before.

Here is a summary of our 1983 budget. The bottom line is $274 billion. We yield to no one as the largest spending agency in the world. Only the Soviet Union and the United States of America spend more money than does my department, and this $274 billion is $56 billion higher than the Defense Department. I would just like to repeat that: $56 billion higher than the Defense Department. My budget will go up $20 billion this year. It will be an increase of 8 percent. It will be twice the rate of increase of all the other departments except for Defense, and I think that these points are well worth noting.

In addition, about 95 percent of my $274 billion is set by entitlements, by social security, by medicare, by medicaid, AFDC and supplemental security income. So if we really want to get control of

my budget and my Department we must deal with the entitlement issue.

During the same period of time, the pro-rata share of my Department's spending in terms of the total Government picture has increased in spite of the so-called cutbacks. And in my Department they are really not cutbacks so much as reductions in growth, because my budget went up $20 billion this year. It went up some $20 billion last year, and the percentage of the Department's budget compared to the total budget is also still going up, not down.

Back in 1970 my Department was 25 percent of the Federal budget. Today it is 35 percent of the Federal budget, and even at the end of the year that we are proposing our budget for, it will be 36.2 percent of the Federal budget—again a significant number of percentage points higher than Defense.

In a nutshell, this chart shows the whole problem of Federal spending. If there is one picture that tells the story of why our Government's Federal spending is out of control, this chart is it. This lists the programs of spending in my Department, but you could well say this graph represented total Government spending in social welfare because the pattern is almost identical.

Back in the early fifties we increased social welfare spending during that decade at a rate of about 82 percent, as you can see from the slope of that line, not quite doubling it. Back in the sixties, in the Great Society-New Frontier years, we increased 188 percent, which turns out to be very modest growth. But in the seventies it leapfrogged up to 313 percent, and there begins the pitfalls and trials and tribulations of what we are in now.

The interesting thing is if we let current law stand, if we do not touch current law, the rate of that curve will go up even more than the seventies, and I think that is really the telling, indicting point of what we have to do. The growth curve will go up if we don't change current law to an even faster rate of growth than the 313 percent. And I think this points up the problem of how it is out of control and what we must try to do.

Another way of looking at it, we have in this budget about $6.8 billion of entitlement reductions of growth, and if you look at this particular chart, this takes it from the 1982 to the 1983 fiscal year. The dotted line shows what happens if we keep current law on the books in terms of entitlement reforms, and the solid line shows what the Reagan budget would do.

So even though we are proposing cutting $6.8 billion in entitlement, it's a very, very modest change in the rate of growth, as you can see from the small difference between those two lines. I can't emphasize that too much because, again, it gets back to how we slow down a rate of growth.

Now in spite of the magnitude of the problem and the parameters I have outlined, I think we have made some progress and I think it is important to say that, because Congress was part of that progress and it can take some credit for it. Back in 1981, when I took office as Secretary, the rate of growth in my Department was 17.8 percent. Now keep in mind a $250 billion budget is growing at the rate of 17.8 percent. You don't have to be a mathematician to figure out that's a horrendous implication, public policy wise.

Because of what the Congress and the President did last year, we significantly changed that rate of growth. The continuing resolution that we are operating under now really had a dramatic impact on that and we are down to about, for the fiscal year we are now in, about 10 percent, while the numbers are big and astronomical. And that's why the curves look so small by comparison.

When you look at the rate of growth, we are beginning to make a turn from 17.8 percent when we took over to about 10 percent. And, you know, that is not too much different from inflation. So while the figures are still big, there are still some significant changes and that is what has been accomplished.

The next part of the curve is what we hope to accomplish with the budget we are presenting before you. Again, this would lower the rate of growth to about 8 percent, so the 10 percent we are operating at now in my Department would be reduced slightly, to about 8 percent, if the budget, and particularly the entitlement proposals that we made, are adopted.

One of the areas, of course, is medicare. As the chairman well knows, medicare and medicaid have been two of our fastest rate of growth programs. We made a proposal to save about $3 billion in medicare and I think it is important to see how we are spreading the burden because it does not primarily fall on the backs of the beneficiaries.

Basically, 37 percent of that savings or economies—whatever you want to call them—would go to the hospitals in terms of their responsibility. I don't have to tell this committee that the hospital costs—and I know the chairman has been a leader in this field and issued a significant challenge to the industry in this area, and I commend him for his initiative—the hospital costs this year have gone up 19 percent by their own count, about 17 percent by the count of the Bureau of Labor Statistics index. But in either count they are up. So we don't think it is unfair to ask them to assume about 30 percent of the burden in trying to slow these costs down.

Federal employees. We are asking them to be covered by the hospital insurance fund, and that is 21 percent factor. Physicians, 18 percent of the burdensharing, and employers and group health plans about 15 percent. The beneficiaries would be asked to assume about 9 percent of that bill. So I think it important to show that there is some equity and some provision to burden-share among the providers of some of the principal people in that fund.

Mr. Chairman, 1 year ago, the cruel reality of inflation and the harm it inflicted prompted the American people to demand that their Government adopt spending reforms. Today it is even more imperative that we utilize discipline in Federal spending, stemming the rate of growth in HHS programs and thus helping reduce inflation.

Most of the budget growth for fiscal year 1983 occurs in entitlement programs—medicare, medicaid, AFDC, SSI, and, of course, social security. Social security benefits will continue at current levels, with full cost-of-living increases. The budget makes no major recommendations concerning social security benefits or financing, pending the report of the National Commission on Social Security Reform.

Head Start's service to disadvantaged children will be continued, as well as the offices on preventive medicine and health promotion, making wellness as pivotal as treating illness.

Last year 25 programs of this Department were consolidated into seven block grants, reducing over 300 pages of Federal regulations to 6. The new budget proposes to consolidate additional programs, thereby accelerating the return of decisionmaking to the States and reducing administrative costs.

Inherent in the President's New Federalism initiative, as in the economic recovery plan, is the idea that the time has come for constructive change, for a sorting out of Federal and State roles. The reforms of the 1983 budget are preliminary to a comprehensive program which will be submitted to the Congress this spring, giving new fiscal resources to the States to assume full partnership in addressing the Nation's domestic concerns.

Mr. Chairman, before getting into the specifics of the programs that I am here to talk about, I would like to take a minute to mention our competition initiative. I firmly believe that part of the solution to moderating various health care costs lies in increasing individuals' participation in decisions about their health care and in increasing the opportunity for competitive forces to operate in the health care industry.

To that end, last spring I established a competition task force within HHS to study proposals to encourage consumers to make more cost-conscious health care choices and to encourage the system to promote diversity while avoiding over-regulation in the medical sector. Recently we sent to the White House a number of options to be considered by the Cabinet Council on Human Resources.

Once selected and their final form established, I believe we will have some positive mechanisms to improve economic incentives among consumers, insurers, and providers for more effective health care, and mechanisms that will permit the powerful influence of consumer choice to foster a healthy balance of competition in the health care market, a market that has suffered badly from the loss of effective consumer participation.

When we discuss the expenditures under medicare, it is critical that we recognize that the total health care expenditures in the United States have increased at least 400 percent since enactment of the medicare and medicaid programs in 1965. The Federal share of that total has increased from $6 billion in 1965 to a projected $59 billion in 1981. In 1982, medicare expenditures are projected to reach a staggering $49.6 billion, or a 16.6-percent increase over last year.

We are also very concerned about hospital costs, which have continued to rise at an intolerably high rate—an estimated 19-percent increase in 1981 alone—and medicare has continued to contribute to this trend by paying whatever the hospital bills are, even as we are trying to reduce inflation in the economy and cut down the size of Federal spending.

The medicare hospital insurance trustees now estimate that because of expected inflation of hospital costs, the trust fund, the Hospital Trust Fund for Medicare, will spend $66 billion under current law in 1987, a dramatic 175-percent increase over its 1980 dis-

bursements. If medicare is to continue to meet the basic health care needs of the elderly, these trends must be checked.

Our fiscal year 1983 budget contains a number of legislative proposals and administrative initiatives which would meet basic health needs yet reform medicare coverage policy and reimbursement to providers, streamline program administration. Major savings resulting from these proposals will be derived primarily through sources other than the beneficiary, as my charts show. These proposals would hold expenditures next year to approximately $3 billion below what they would otherwise be, and generate additional trust fund revenue of $600 million. Mr. Chairman, these reforms are vital if we are to maintain the integrity of the medicare program.

In developing the 1983 budget, every open-ended entitlement program was closely examined for possible reforms. In the SSI program we identified a number of relatively minor changes which fall into three categories: relating SSI benefits more closely to an individual's income and circumstances, tightening the eligibility requirements for disability benefits in the SSI program, and simplifying program administration.

The social service block grant, under title XX of the Social Security Act, enacted as part of the Omnibus Budget Reconciliation Act of 1981, was implemented in fiscal year 1982. This block grant program was designed to provide States with greatly increased flexibility in determining priorities among the needs of their population and in allocating resources among those priorities.

A level of $1.974 billion is required for the social security services block grant to continue support for the variety of social services authorized by this program. These include, but are not limited to: child and adult day care services, protective services, foster care, transportation, family planning, training, information and referral, counseling, delivery of meals and health support. In addition, a State may use a portion of its allocation to support work incentive programs, including related child care and supportive services.

However, we expect that in fiscal year 1983, as in fiscal year 1982, the States will be in a position to use a greater latitude in the use of these funds to develop more efficient and effective social services delivery systems.

As part of this same effort, we are proposing the consolidation of the major Federal children's services authorities under title IV of the Social Security Act: child welfare services and training, foster care, and adoption assistance. The authorizing legislation for this block grant is now being developed, and we believe we have crafted a program which reduces the Federal burden on States while retaining the essential protections for children in foster care and for those receiving child welfare services.

The administration is proposing a number of additional changes in the AFDC program which will insure that assistance is provided only to those who are in need and cannot provide for themselves; strong work requirements exist; and administration of the program is improved. Several of our proposals would require that in determining a family's need for AFDC all sources of income available to the family will be considered, including the contribution of individuals who share a household with an AFDC unit.

We seek to further reduce the duplication of payments by different programs for the same need and to provide assistance only to those adults who still have substantial family responsibilities in the home. We believe that employable adults whose youngest child is 16 are sufficiently free from family responsibilities to no longer require assistance.

Several other proposals are designed to strengthen work requirements and improve the employability of recipients. We propose to require that all able-bodied individuals who are not caring for young children and who request assistance begin a job search as soon as they apply. We also believe that those whose search is unsuccessful and who become recipients should be required to actively participate in a community work experience program, work supplementation program, or other activity designed to increase their employability through actual work experience.

We envision that States will include greatly expanded employment activities as an important feature of their AFDC programs in order to move recipients from welfare dependency to self-sufficiency.

We propose to eliminate, over several years, Federal matching for erroneous AFDC benefit payments and to establish a consolidated grant to combine and cover State and local costs of administering the AFDC, medicaid and food stamp programs at 95 percent of the fiscal year 1982 level. Both of these proposals offer strong incentives for States to tighten administration of these programs.

The Federal Government presently pays a great preponderance of the administrative costs of the child support enforcement program and provides a wide range of services and technical assistance to the States. We propose to restructure the financing of the child support enforcement program to promote the cost effectiveness and efficiency of State and local operations and reward States for exemplary performance.

In addition, we propose to require the States to retain a percentage of collections from non-AFDC cases to offset the administrative costs of processing these cases. Finally, we propose to simplfy the collection of certain child support payments to increase State flexibility in the administration of their programs.

These are the major aspects of the fiscal year 1983 budget that have come under the jurisdiction of the House Committee on Ways and Means. The important thing overall is that we bring reckless Federal spending under control. The only way to do that is to limit Federal expenditures to those that are necessary and to restructure existing programs in such a way as to curb abuse, avoid duplication, and streamline administrative costs.

I will be happy to answer questions that you or any other Members of the Committee may have. Thank you.

[The prepared statement follows:]

STATEMENT OF HON. RICHARD S. SCHWEIKER, SECRETARY OF HEALTH AND HUMAN SERVICES

Mr. Chairman and members of the Committee, I appreciate the opportunity to appear today before the House Committee on Ways and Means, to discuss relevant portions of the President's Budget for Fiscal Year 1983.

The budget we present for fiscal year 1983 builds upon the new course we began last year: it is based on helping those most in need, a new partnership with the

states, fiscal responsibility, reform of our entitlement programs and regulatory *relief.*

We will maintain our leadership role in health research and in disease prevention and control. We will confront the hard facts of health care cost inflation.

Overall, the 1983 budget for Health and Human Services will total $274.2 billion in outlays, an increase of $20 billion or 8 percent over 1982. Our share of the federal budget increased to 36 percent—still more than all 50 states combined and more than the budget of any nation on earth except the United States and the Soviet Union, and $56 billion more than the Defense budget.

One year ago, the cruel reality of inflation and the harm it was inflicting prompted the American people to demand that their government adopt spending reforms. Today, it is even more imperative that we utilize discipline in federal spending, stemming the rate of growth in HHS programs, thus helping reduce inflation.

Most of the budget growth for fiscal year 1983 occurs in entitlement programs—Medicaid and Medicare, AFDC and SSI, and, of course, Social Security.

Social Security benefits will continue at current levels with full cost-of-living increases; the budget makes no major recommendations concerning Social Security benefits or financing, pending the report of the National Commission on Social Security Reform.

Head Start's service to disadvantaged children will be continued, as will our emphasis on preventive medicine and health promotion, making "wellness" as pivotal as treating sickness.

Last year, 25 programs of this department were consolidated into seven Block Grants, reducing over 300 pages of federal regulations to six. The new budget proposes to consolidate additional programs, thereby accelerating the return of decisionmaking to the states and reducing administrative costs.

Inherent in the President's Federalism initiative, as in the Economic Recovery Plan, is the idea that the time has come for constructive change, for a "sorting out" of federal and state roles. The reforms of the 1983 budget are preliminary to a comprehensive program, which will be submitted to the Congress this spring, giving new fiscal resources to the states to assume full partnership in addressing the nation's domestic concerns.

Mr. Chairman, before getting into specifics of the programs that I am here to talk about, I would like to take a minute to mention our competition initiative. I firmly believe that part of the solution to moderating various health care costs lies in increasing individual's participation in decisions about their health care and in increasing the opportunity for competitive forces to operate in the health care industry. To that end last spring I established a competition task force within HHS to study proposals to encourage consumers to make more cost conscious health care choices and to encourage the system to promote diversity while avoiding overregulation in the medical sector.

Once our competition initiative is completed and implemented I believe we will have some positive mechanisms to improve economic incentives among consumers, insurers and providers for more cost effective health care—and mechanisms that will permit the powerful influence of consumer choice to foster a healthy balance of competition in the health care market—a market that has suffered badly from the loss of effective consumer participation.

MEDICARE

Let me now turn to proposals relating to the Medicare program. Mr. Chairman, when we discuss the expenditures under the Medicare budget it is critical we recognize that total health care expenditures in the U.S. have increased at least 400 percent since enactment of the Medicare and Medicaid programs in 1965: the Federal share of that total has increased from $6 billion in 1965 to a projected $59 billion in 1981. This country's expenditures on health care are now well over $200 billion a year and are expected to reach $821 billion in 1990; which translates to 10.8 percent of GNP, up from 9 percent in 1979.

Costs of the Medicare program in 1980 were $35 billion, a 20 percent increase over 1979. Medicare expenditures in 1981 were $42.5 billion, a 21,4 percent increase over 1980. In 1982, Medicare expenditures are projected to reach a staggering $49.6 billion, or a 16.6 percent increase over last year.

Another index with which we are very concerned is hospital costs which have continued to rise at an intolerably high rate—an estimated 19 percent increase in 1981 alone—and Medicare has continued to contribute to this trend by paying whatever the hospital bills are, even as we are trying to reduce inflation in the economy and cut down on the size of Federal spending.

It is important to remember too that hospitals are a major recipient of Medicare and Medicaid reimbursements and they rely on this source for their continued existence. Therefore, we believe they must be willing to share in the burden of reducing Federal expenditures in order to guarantee over the long-term, the financial viability of these programs.

The Medicare Hospital Insurance trustees now estimate that because of expected inflation in hospital costs, the fund will spend $66 billion under current law in 1987—a dramatic 175 percent increase over its 1980 disbursements. Expenditures under the hospital insurance program are of critical importance for they comprise 67 percent of all Medicare expenditures. If Medicare is to continue to meet the basic health care needs of the elderly, these trends must be checked.

Our fiscal year 1983 budget contains a number of proposals which would meet basic health needs yet reform Medicare coverage policy and reimbursement to providers as well as streamlining program administration. Major savings resulting from these proposals will be derived primarily through those provisions affecting reimbursement of hospitals and physicians, coordination with other insurance plans, and coverage of Federal employees under Medicare. Our 1983 Medicare proposals would hold expenditures next year to approximately $3 billion below what they would otherwise be, and generate additional Trust Fund revenue of $600 million.

Briefly, those proposals are:

Bring Federal employees under Medicare Part A. Applying the Hospital Insurance tax to Federal employee wages will result in $1,238 million in additional revenue to the trust fund in fiscal year 1983, and $619 million in net deficit reduction. For the first time, Federal workers would become eligible for Medicare based on their Federal employment.

Modify Medicare coverage of the working aged. This proposal would result in net Federal savings of $303 million in fiscal year 1983. Employers would be required to offer employees ages 65 to 70 the same health benefit plan offered to younger workers. This would reverse the present situation where Medicare has subsidized employers for much of the cost of providing health benefits to older employees.

Further, we will propose legislation that would provide the Department with additional discretion regarding the way we contract with Medicare intermediaries and carriers. This reform will allow the selection of a contract arrangement, such as a competitively bid, fixed-price contract, which will produce the most economical results in a variety of circumstances.

Reimburse Hospitals at 98 percent of reasonable costs. Federal savings from this proposal would equal $688 million in fiscal year 1983. The decrease of 2 percent in reimbursable hospital costs allowed by Medicare would be an interim step pending development of a long-term solution to the very serious problem of rising hospital costs I mentioned earlier. This approach is similar to the Medicaid cost reductions adopted by the Congress in the Omnibus Budget Reconciliation Act of 1981 and has the same goal—reducing the rapid rate of increase in Federal health care expenditures.

Limit the increase in physician payments by holding the Economic Index to 5 percent in 1983. Total savings from this proposal would amount to $37 million in fiscal year 1983. This one-time limit would place on physicians a share of the responsibility for slowing the growth of health care expenditures, at a time of severe constraints on the Federal budget.

Reimburse inpatient radiology and pathology services at 80 percent of reasonable charges, the same level as all other physicians' services under Medicare. Thus, reimbursement for these specialty services in the same manner as all other physicians' services under Medicare, would result in savings of $160 million in fiscal year 1983.

Establish targets to reduce unnecessary use of hospital and medical care saving $372 million in fiscal year 1983.

Institute copayments for home health services to reduce unnecessary use of these services and provides savings of $35 million in fiscal year 1983. Home health services are currently free and unlimited. As a result, the program is growing at an annual rate of almost 30 percent. Modest copayments would be established to encourage beneficiary cost-consciousness in the use of the service. The copayment would be 5 percent for the first 100 visits (about $2.40 and 20 percent thereafter.)

Index the SMI deductible. The current $75 deductible would be indexed to the Consumer Price Index in order to keep its economic value constant. This would produce savings of $65 million in fiscal yar 1983.

Establish Medicare eligibility at the beginning of the first full month after attaining age 65 rather than the beginning of the month in which the birthday occurs. This change would conform Medicare practices to similar changes proposed for other entitlement programs and save $145 million in fiscal year 1983.

In addition to these legislative proposals, we will also undertake a number of administrative initiatives, including the elimination of duplicate Medicare payments for services in outpatient departments—saving $160 million in fiscal year 1983. Physicians providing care in hospital outpatient departments are now paid the same rate by Medicare for services as the physicians would be if the services were performed in their private offices. This is true even though the hospital is often reimbursed for overhead costs. We propose, therefore, to refine the application of the Medicare "customary and prevailing charge" screens to reflect more accurately the allowable charges for professional services provided in different locations.

The Administration also proposes to establish objectives for Medicare contractor activities and cooperate with private sector efforts to reduce unnecessary days and other services. At the same time, current provisions which waive provider liability for the cost of unnecessary or uncovered care would be eliminated.

Mr. Chairman, the legislative and administrative proposals I have just discussed are vital if we are to bring about needed reforms in the Medicare program. Without such steps, maintaining the integrity of Medicare may be an impossible task. Just as all Americans and all sections of the economy will share in the fruits of a healthy economy, so must they share in the sacrifice necessary to accomplish this task. Hospitals and physicians cannot be exempt from contributing to the fight against inflation.

SSI AND OASDI

Let me now turn to proposals relating to the SSI program and then to some changes that also affect administration of the OASDI system of Social Security.

SSI

In developing the 1983 budget, every open-minded entitlement program was closely examined for possible reforms. In the SSI program, a number of relatively minor changes were identified. These changes fall into three categories:

Relating SSI benefits more closely to an individual's income and circumstances;

Tightening the eligibility requirements for disability benefits in the SSI program; and,

Simplifying program administration.

Included in the first category of relating benefits more closely to need are the following changes:

A proposal to end for future beneficiaries the special advantage that SSI recipients with other income get as a result of the present provision for disregarding up to $20 a month of any income in the calculation of DDI monthly payments. The present provision helps those with some income other than SSI—not those who are wholly reliant on SSI. The SSI benefits to persons receiving only SSI will not be reduced by this change. Those who now benefit from the exclusion will continue to do so as long as they remain continuously eligible. This proposal will save about $15 million in fiscal year 1983; and

A proposal to prorate the first month's benefit to reflect the actual date of application or first eligibility (if later). This change will eliminate payments for that part of a month preceding the person's benefit eligibility and application for payments and will save $40 million in fiscal year 1983.

I am presenting two proposals which would help ensure that SSI disability benefits are paid only to recipients who are totally and permanently disabled. They are:

Changing the definition of "permanent disability" to require that an individual's impairment must be expected to last at least 24 months, rather than the current 12 months. This change will save $45 million in fiscal year 1983; and

Giving greater consideration to objectively-determined medical factors in determining whether or not an individual is disabled rather than nonmedical factors (such as age, education, and work experience) which are much more subjective and result in inconsistent decisions. This change will save $75 million in fiscal year 1983.

In order to simplify program administration, I offer:

A proposal to round the maximum monthly SSI payment and actual benefit amount to the next lower dollar. Title II Social Security benefits are already rounded to the next lower dollar under a provision of the Omnibus Budget Reconciliation Act of 1981. SSA is taking administrative steps to assure that final payment amounts—after taking account of individual income—will also be in whole dollars. This proposal will save $20 million in fiscal year 1983.

In addition, I want to present several technical proposals which merit your attention:

A modification to the provision for retrospective monthly accounting for SSI, which was enacted as part of the Omnibus Budget Reconciliation Act of 1981. That provision has the unintended effect of giving SSI recipients who also receive Social Security benefits an extra increase for the months of July and August as a result of the regular July cost-of-living increases. SSI recipients would not receive the proper payment amount until September.

Last fall, this Committee adopted a proposal which, in effect, repealed the whole system of retrospective accounting for SSI that the Congress had just approved. That proposal, passed in the House, has not been acted upon in the Senate. We propose, instead, a less far-reaching modification which will assure smooth coordination of the cost-of-living increases in Social Security and SSI while retaining the overall advantages of the retrospective accounting system. This proposal would restore the projected savings of $20 million in fiscal year 1982 and $40 million in fiscal year 1983.

We propose a change which would remove an unintended limitation in the applicability of the provision in the Omnibus Budget Reconciliation Act of 1981 which dealt with unnegotiated SSI checks. This amendment would make clear that the procedures of notice by the Department of the Treasury and the follow-up investigation by the Secretary of Health and Human Services apply in the case of all checks issued under the SSI program that remain uncashed for more than 180 days, whether or not State supplementary payments are included in the checks. In addition, the technical amendment relating to checks containing only mandatory State supplementation that this Committee reported last fall is included in the technical section of our proposed bill.

We are proposing a four year phase out of the "hold-harmless" provision. This change affects only Hawaii and Wisconsin and is necessary because, as a result of changes adopted in the late 70's, the "hold-harmless" provision did not phase itself out as a result of increases in the Federal SSI benefit as originally intended. The first stage of this change, affecting the fiscal year 1982 "hold-harmless" amounts, is reflected in the current continuing resolution.

We are also proposing the elimination of the mandatory pass-through provision. The current pass-through requirement, in effect since July 1977, mandates continuing State fiscal participation in the SSI program. By repealing the pass-through requirement, our proposal would return to the States the basic freedom to decide how much of their revenues would be spent on supplementation programs. Mandatory pass-through restricted that freedom by establishing minimum supplementation and expenditure levels below which the States are not free to go without forfeiting Federal funds under the Medicaid program. By repealing the pass-through requirement, our proposal would return to the States the basic freedom to determine the extent to which they wish to supplement Federal SSI benefits and, as a result, provide them with a greater degree of control over their expenditures.

Finally, to protect the food stamp cash-out status of California and Wisconsin in light of the foregoing changes, we are modifying the cash-out requirements. States would be permitted to retain cash-out status so long as they agree to provide a supplement equivalent to the value of food stamps that an individual or a couple with only SSI income could receive.

SOCIAL SERVICES AND CHILD WELFARE

The fiscal year 1983 budget for social services activities continues the effort begun in fiscal year 1982 to increase State flexibility in the programming and administration of program resources and to simplify Federal administrative and oversight responsibilities. The Social Services Block Grant under Title XX of the Social Security Act, enacted as part of the Omnibus Budget Reconciliation Act of 1981, was implemented in fiscal year 1982. This block grant program was designed to provide States with greatly increased flexibility in determining priorities among the needs of their population and in allocating resources among those priorities. Interim final regulations for this and the other six HHS block grants were published on October 1, 1981.

A level of $1,974,126,000 is requested for the Social Services Block Grant to continue support for a variety of social services at the State level. The amount requested represents approximately 82 percent of the amounts States received in fiscal year 1982. Services which a State may choose to provide may include, but are not limited to: child and adult day care services, protective services, foster care, transportation, family planning, training, information and referral, counseling, delivery of meals, and health support. In addition, a State may use a portion of its allocation to support work incentive programs, including related child care and supportive services.

Since we are less than halfway through fiscal year 1982, the Department does not yet have available specific data on use of the social services block grant funds by the States. We hope to have preliminary data later this spring. However, we expect that in fiscal year 1983, as in fiscal year 1982, the States will be in a position to use the greater latitude in use of these funds to develop more cost efficient and effective social services delivery systems.

As part of this same effort to increase State flexibility in management of social services programs, we are proposing this year the consolidation of the major Federal children's services authorities under Title IV of the Social Security Act: Child Welfare Services and Training, Foster Care and Adoption Assistance. The proposed authorizing legislation for this block grant is now being developed. The proposal is not yet final, but we believe we have crafted a program which reduces the Federal burden on the States, while at the same time retains the essential protections for children in foster care and for those receiving child welfare services that are embodied in the Adoption Assistance and Child Welfare Act of 1980.

A level of $380,120,000 is requested for the new Child Welfare Block Grant authority. The amount requested represents 82 percent of the comparable fiscal year 1982 level for the activities proposed for consolidation in this appropriation. This request is based on the assumption that Congress will enact the required enabling legislation prior to the enactment of fiscal year 1983 appropriations.

As I noted earlier, we are proposing to allow States to fund work incentive programs, including child care and supportive services, under the Social Services Block Grant, and will be proposing appropriations language to this effect. No funds are proposed for a separate WIN program in fiscal year 1983. Eligibility changes in the AFDC program enacted in the Omnibus Budget Reconciliation Act of 1981 and proposed in the fiscal year 1983 budget, in particular mandatory community work experience programs, minimize the need for a separate WIN program.

We believe that the overall effect of these changes in the social services programs will be to allow States to maximize resources and administer programs within their jurisdictions to best respond to circumstances and priorities within their States.

AFDC

The Administration is proposing a number of additional changes in the AFDC program, the basic federally-assisted cash assistance program. These are intended to complement the changes adopted last year as part of Omnibus Budget Reconciliation Act and to further ensure that assistance is provided only to those who are in need and who are not in a position to provide for themselves; that strong work requirements exist; and that administration of the program is improved.

Several of our proposals would require that, in determining a family's need for AFDC, all sources of income available to the family will be considered. These proposals would end the practice whereby families exclude members with income from the assistance unit in order to maximize benefits. They would also require States to recognize the contribution of individuals who share a household with an AFDC unit. We seek, also, to further reduce the duplication of payments by different programs for the same need to provide assistance only to those adults who still have substantial family responsibilities in the home. We believe that employable adults whose youngest child is 16 are sufficiently free from family responsibilities to no longer require assistance.

There are several other proposals designed to strengthen work requirements and improve the employability of recipients. The administration believes that all able-bodied individuals who request assistance should be involved in some type of work-related activity or job search from the day they apply. We propose to require: that all applicants who are able to work and not caring for young children be required to begin a job search as soon as they apply for assistance; that those whose search is unsuccessful and who become recipients be required to actively participate in a community work experience program, work supplementation program, or other activity designed to increase their employability through actual work experience, and in continued job search at intervals set by the State; and that placement in private sector employment will remain the foremost goal for these individuals.

We envision that States will include greatly expanded employment activities as an important feature of their AFDC programs. To move recipients from welfare dependency to self-sufficiency is a goal universally shared.

We also have 2 proposals aimed at reducing administrative inefficiency. We propose to eliminate over several years Federal matching for all erroneous AFDC benefit payments and to establish a consolidated grant to combine and cover State and local costs of administering the AFDC, Medicaid, and Food Stamp programs at 95

percent of the fiscal year 1982 level. Both of these proposals offer strong incentives for States to tighten administration of these programs. We believe that public acceptance of and support for assistance programs will be enhanced if we can ensure that administrative costs are kept to a minimum, that only eligible individuals receive assistance and that they receive only the amount to which they are entitled.

CHILD SUPPORT ENFORCEMENT

The Child Support Enforcement program assists States in enforcing the support obligations of absent parents to their children, locating absent parents, establishing paternity and obtaining child support. These services are provided to AFDC families and are available upon request to families who are not recipients of public assistance in recognition of the cost avoidance or deterrent value of such services. The Federal Government presently pays the great preponderance of the administrative costs of the program and provides a wide range of services and technical assistance to the States.

A major legislative initiative will be proposed to restructure the financing of the Child Support Enforcement Program. While Federal funds were essential at the time of enactment of the basic authorizing legislation in 1975, the Child Support Enforcement Program has now attained a degree of maturity. However, there is ample evidence to demonstrate that the cost-effectiveness and efficiency of State and local operations can and should be improved.

On a nationwide basis, there is a still untapped potential to increase child support collections. Program effectiveness varies widely from State to State. Costs are often excessive in relation to support collection. The net result is a deficit to be borne by the Federal Government, under current law, of $191 million in fiscal year 1983. Our restructuring proposal will establish a clear focus on performance, and serve as tangible recognition of superior performance.

A related theme of the Child Support Enforcement legislative proposals is flexibility, giving States the opportunity to make priority choices and to apply workable and worthwhile means to enhance performance in the context of their own individual circumstances. One aspect of this approach, for example, will be a legislative proposal to refocus the Child Support Enforcement audit activity to a concern with program efficiency and effectiveness rather than preoccupation with process alone.

Another Child Support Enforcement legislative proposal seeks to change the method by which States recover administrative costs incurred for the provision of services to custodial parents who are not recipients of AFDC. Last year the Congress enacted a provision on this subject as part of the Omnibus Budget Reconciliation Act. By general consensus, the law as it now stands—while well-intentioned—is administratively expensive, cumbersome, and burdensome on the State Child Support Enforcement Programs. In its place, we will propose legislation requiring States to retain a percentage of collections from non-AFDC cases to offset the administrative costs of processing these cases.

Finally, under current law, there are a number of relatively minor statutory restrictions which make the collection of certain child support payments unnecessarily difficult. We are proposing a series of provisions to overcome these restrictions and, in the process, increase State flexilibilty in the administration of their Child Support programs.

LOW-INCOME HOME ENERGY ASSISTANCE BLOCK GRANT

For fiscal year 1983 the Administration is proposing to spend $1.3 billion on a block grant combining the low income home energy assistance block grant with emergency assistance provided under title IV-A of the Social Security Act. The new block grant will allow for more efficient provision of emergency assistance and for coordinating this aid with energy assistance.

No states could eliminate duplicative administrative mechanisms and criteria now required for the two programs. Reporting requirements, assurances and compliance procedures also would be reduced or eliminated, thereby providing for increased flexibility and reduced burden for the States. In addition, Federal administrative costs would be reduced by about $1 million as a result.

Mr. Chairman, these are the major proposals accompanying the Fiscal Year 1983 budget, that come under the jurisdiction of the House Committee on Ways and Means. The important thing overall is that we bring reckless Federal spending under control. The only way to do that is to limit Federal expenditures to those that are necessary, and to restructure existing programs in such a way as to curb abuse, avoid duplication, and streamline administrative expenses. I will be happy to answer questions that you or Members of the Committee may have.

Department of Health and Human Services

1981 HHS Accomplishments

I. A New National Health Agenda

A. Wellness

— NIH Basic Research

— PHS Task Force: Medical Schools Cooperation

— Public Education

— Sodium Labelling

— Private Sector Programs Being Encouraged

B. Consumer Choice and Competition Proposals

— Task Force Options Look to Positive Incentives including:

- Offer a Range of Choices to Employees
- Vouchers for Medicare Choices
- Medicare Cost Sharing and Catastrophic Coverage

C. Preserved Vital Research at NIH

Department of Health and Human Services

1981 HHS Accomplishments (Continued)

II. Deregulation
   A. Block Grants to States
   B. Phase out Federal Health Planning Role
   C. Started Closing the "Drug Lag"

III. Crackdown on Waste, Fraud and Abuse of Tax Dollars

IV. Transferred PHS Hospitals to New Uses

V. Targeted Welfare Benefits

VI. Reduced Size and Cost of Federal Bureaucracy
   — Cut HHS Employment by 7% or 10,860
   — HHS Travel Expenses Cut by 20%

Department of Health and Human Services

Summary of FY 1983 Budget

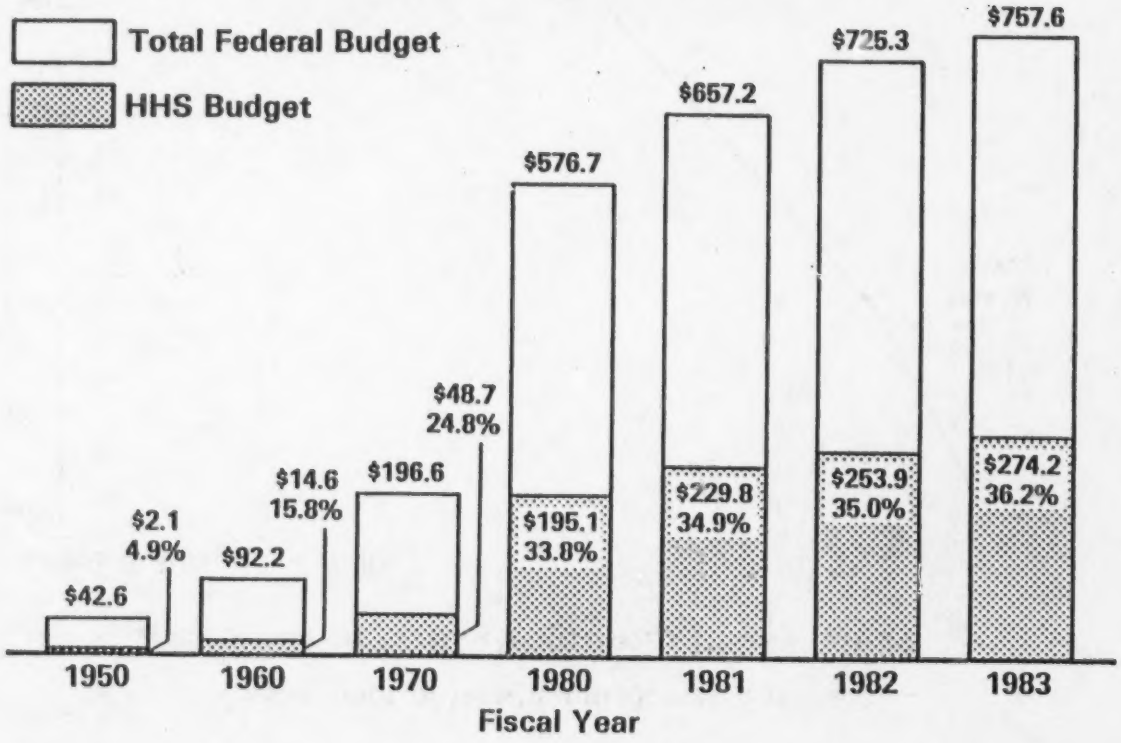
(Dollars in Millions)

	Budget Authority	Outlays
Public Health Service	$ 7,782	$ 8,303
Health Care Financing Administration	67,990	68,052
Social Security Administration	187,464	192,524
Offices of Human Development Services and Community Services	4,931	5,046
Departmental Management/Other	244	240
Total, HHS	$268,411	$274,165

- FY 1983 HHS budget includes increases of $20.3 billion in outlays (8%) compared to 1982.

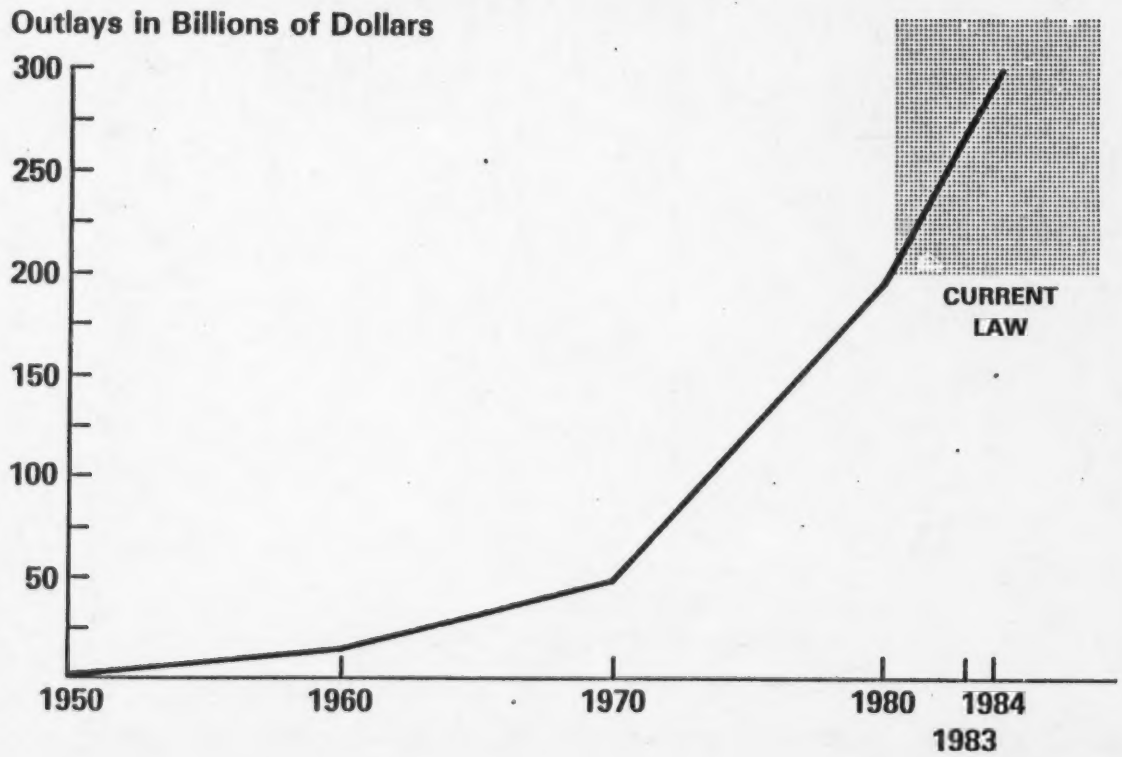
Department of Health and Human Services

HHS Percentage of Federal Budget Outlays in Billions of Dollars



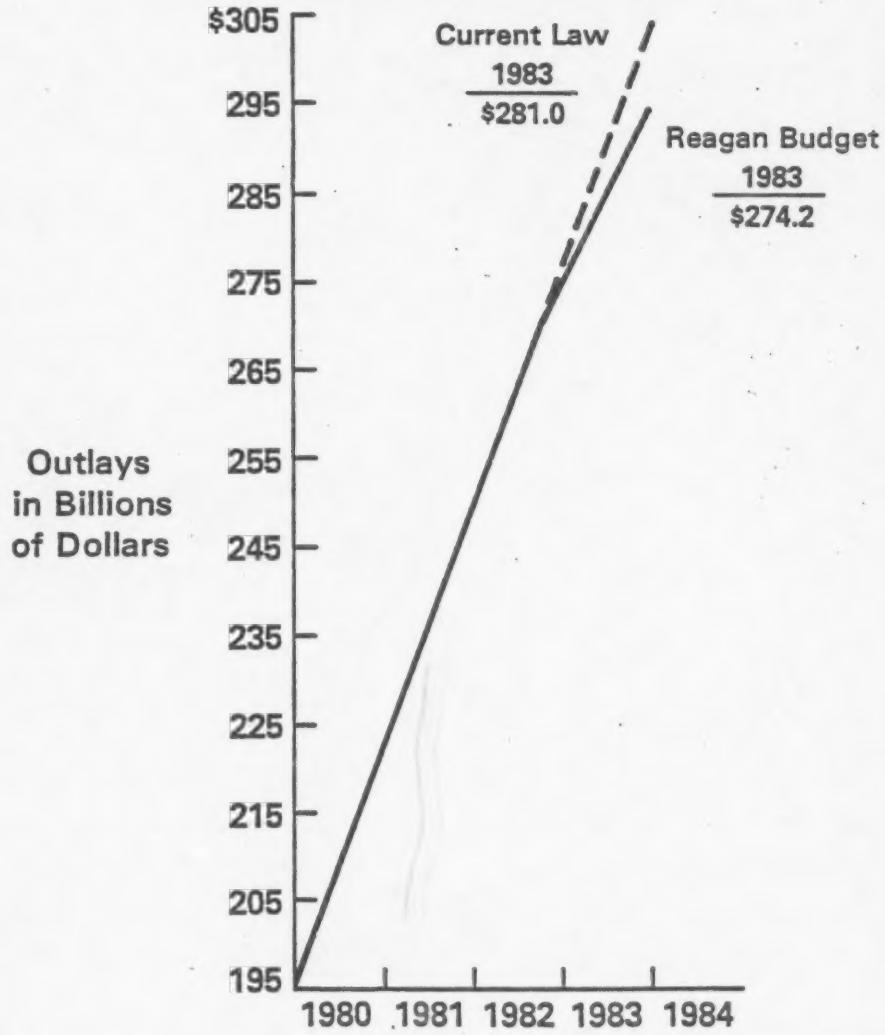
Department of Health and Human Services

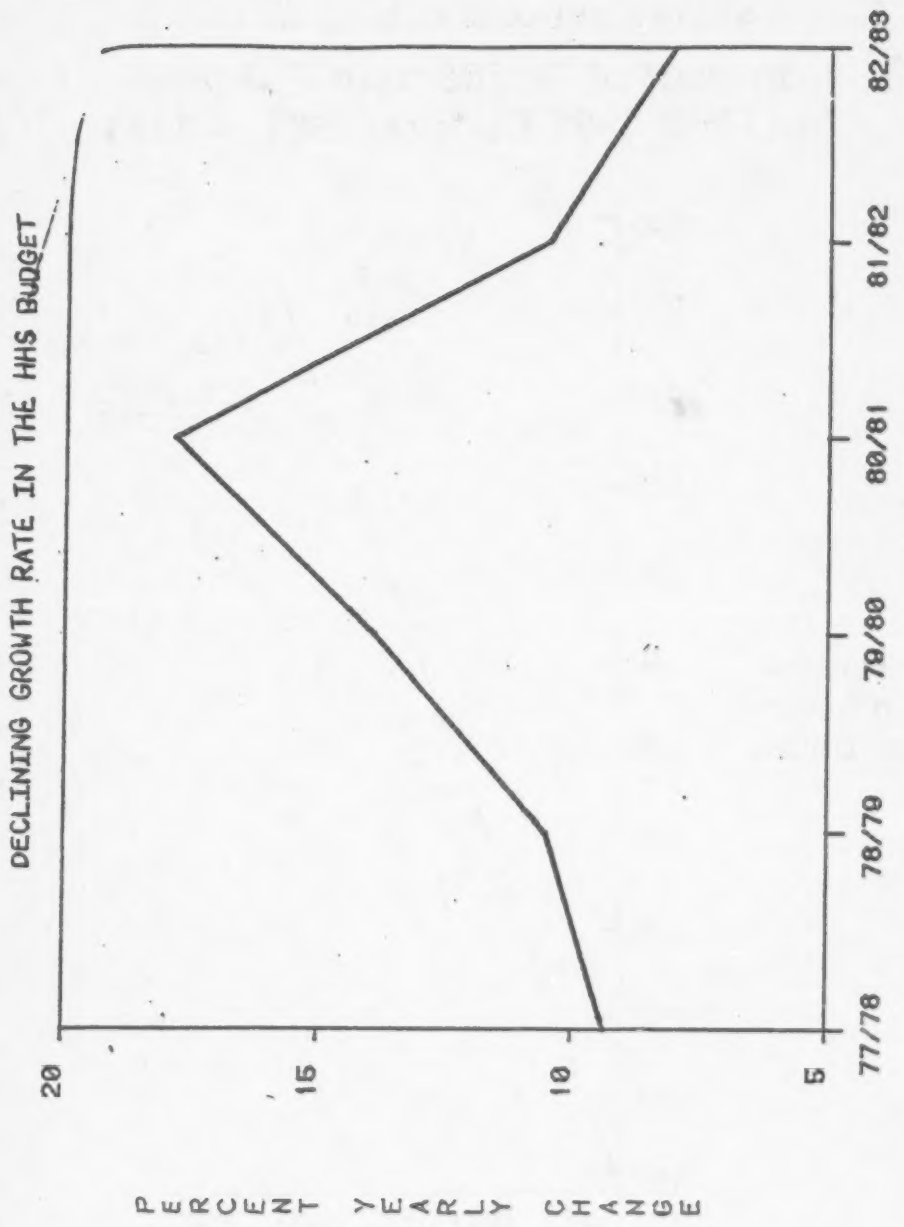
Growth of HHS Programs, 1950 — 1984



Department of Health and Human Services

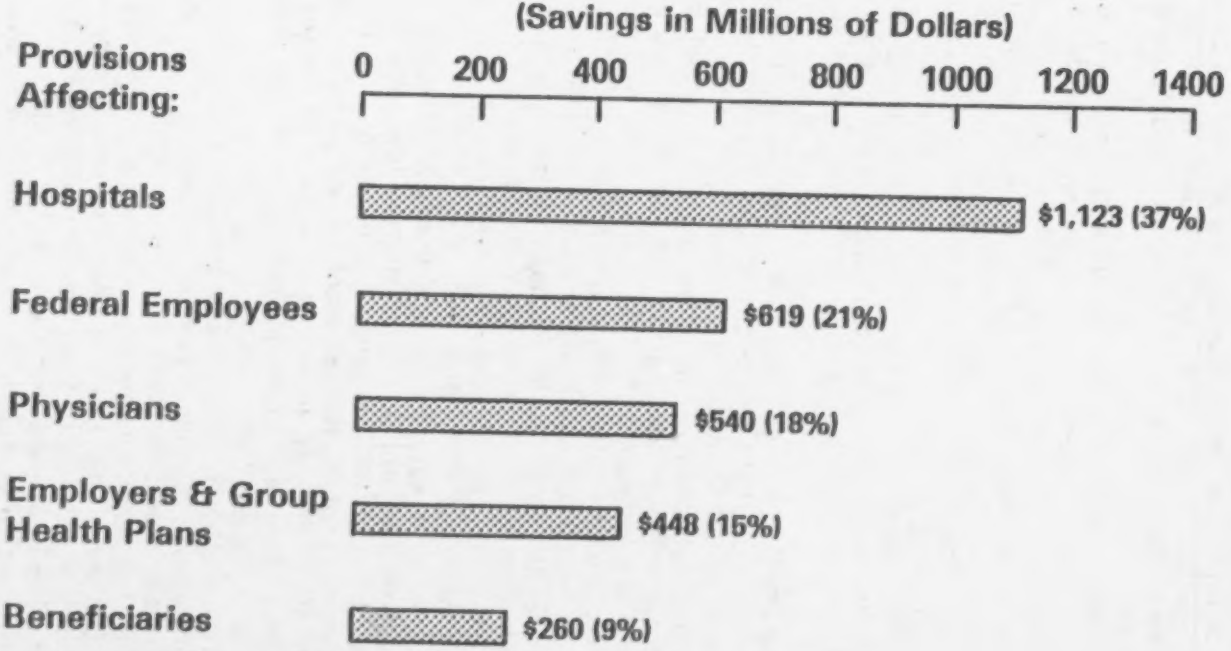
Impact of Entitlement Reforms on HHS 1983 Budget, 1980 — 1984




DECLINING GROWTH RATE IN THE HHS BUDGET
PERCENT YEARLY CHANGE
20
15
10
5
77/78
78/79
79/80
80/81
81/82
82/83
FISCAL YEAR

Department of Health and Human Services

Where FY 1983 Medicare Savings Will Come From



Chairman ROSTENKOWSKI. Thank you very much, Mr. Secretary. Mr. Secretary, the Reconciliation Act of 1981 modifies and limits the application of earned-income disregards in the AFDC program, which were designed to provide welfare recipients with financial incentives to work.

We received testimony last December in this area and there were several instances where welfare mothers declared that it was to their advantage to quit work in order to go on welfare. We were quite concerned with that and I am sure you should be. There has been some discussion about changing the law so that the person who is working is given incentive to stay on the job and is not attracted to going on welfare.

I wonder whether or not you would find it agreeable for us to work in this area with your department to solve some of these problems. Have you in any way come across anything like this, Mr. Secretary?

Secretary SCHWEIKER. Mr. Chairman, there is no question that you are caught between two conflicting pressures here. One of them is to target the benefits to those most in need and there is no question that is basically what we are doing and what you were addressing in terms of the hearing was the direct result of that.

By the same token, I think so far, to date, we see no significant evidence that the effect was a decreased work effort. First of all, many recipients are subject to sanctions for quitting work or voluntarily reducing their hours, so they are, basically, required to work. So while they may think they can temporarily gain something, in fact they can't. The mandatory requirement to search out a job or to work obviously eliminates that.

But I want to say this to the chairman. I think this is a valid point to consider and if the committee has some areas to look at here we certainly will, because I think we don't want to see a work disincentive develop. But we want to be careful in whatever we do that we don't build it up as sort of a catch-22 thing where it really just fosters a system where people never step up that last effort to gain self-sufficiency.

So I think the chairman has a point, but I think we want to be a little bit discriminating in how we proceed in addressing it.

Chairman ROSTENKOWSKI. Mr. Secretary, do you have any data on what happened to families who were removed from the AFDC rolls? Did the changes of last year encourage more or fewer AFDC recipients to take jobs? Does the Department have any records as to just what happened with those AFDC recipients?

Secretary SCHWEIKER. I have some caseload figures.

Chairman ROSTENKOWSKI. Well, it has been brought to my attention. I am suggesting to the committee that a study be conducted. Is your Department going to pursue a study in this area?

Secretary SCHWEIKER. Yes, there is a study under way in this area, Mr. Chairman, and I can either give you some of the preliminary indications here or we can give you the complete study when it is completed. We don't have the study completed yet.

Chairman ROSTENKOWSKI. I hope that you can share that with us, Mr. Secretary, at your earliest convenience.

Mr. Conable will inquire.

Mr. CONABLE. Thank you. Mr. Secretary, welcome to the committee. There have been a lot of wonderful new budget proposals floated up here. Somebody said it was like the blooming of 1,000 flowers. So far they have been mostly over in the Senate, so I guess 100 would be the right amount. I suspect, though, that a lot of them are going to, on closer view, look more like toadstools than flowers to the average Congressman.

But I am kind of curious to know if there have been any second thoughts about the freezing of COLA's down at HHS. My impression is that the administration's view on that has not really changed all that much, and I am not sure that it should, at least pending the Social Security Commission's report, which is due on November 10 of this year.

But I want to be sure that there hasn't been any change in the view of the administration as to where we are headed in trying to get control of, admittedly, a too dynamic budget and to reduce the too great deficit that all of us are concerned about. Has there been any change in the administration's thinking about that? I assume you are willing to discuss it with responsible Members of Congress. But you have not changed your position, have you?

Secretary SCHWEIKER. That is basically correct, Congressman. First of all, let me say that once the President appointed the Commission we really stopped all of our activity and our programing because we felt in deference to the Presidential Commission that they should have the lead role.

In fairness to Chairman Greenspan, who I think is a good appointment, I purposely have not even injected what our past positions were into the thing, because I felt that we shouldn't prejudge what he and the Commission may or may not recommend. So the answer is, clearly, we have not changed our position.

By the same token, I also have put us in the position that we don't want to prejudge what the Commission may do, and we are going to try to keep an open mind about it.

Mr. CONABLE. I thank you, because I know there is a lot of confusion about this. And some of the statements coming out of the White House indicate a willingness to discuss, but that does not represent a change of position in any way, I take it. Thank you.

Chairman ROSTENKOWSKI. Mr. Downey will inquire.

Mr. DOWNEY. Thank you, Mr. Chairman.

Yesterday before a Budget Committee, Mr. Secretary, a group of Catholic bishops said that they found that the cuts imposed last year were creating terrible hardship on the poor. They characterized any further cuts this year as morally intolerable. How would you comment to those bishops, Mr. Secretary?

Secretary SCHWEIKER. Well, there is no question that our cuts had some impact in spending. I think the fact that——

Mr. DOWNEY. What about on the poor, as opposed to spending?

Secretary SCHWEIKER. Well, what I am trying to say is that our rate of growth went from 17.6 percent a year down to 10 percent a year. So there is no question that our objective was to slow down that rate of growth. But as you can see from our budget, it is still 8 percent higher in the year past. In the year in it is 10 percent higher. So a $20 billion increase is still an increase.

Now, I think, Congressman, what you are getting at, you can analyze selectively where the impact is, and we certainly have kept an open mind about it. I do not think we have gotten any wide-scale reports or any significant findings, either statistically or in our studies, that they really are having a definitely adverse impact across the country.

Mr. DOWNEY. Mr. Secretary, let me just try to highlight some of the parts of their testimony. They have a number of dioceses across the country that, through Catholic charities, provide services to people. In my own congressional district, for instance, the churches that do provide services have been inundated.

Now, you cite for me and to this committee numbers. The bishops and a number of us are concerned about people. We think that these cuts are hurting people, Mr. Secretary. Do you have any appreciation for the people who are being impacted by the cuts, who have been and who potentially may be?

Secretary SCHWEIKER. Well, I guess I have concern in several respects. I think I certainly have concern for the people involved, and that is why my budget represents an increase of $20 billion over the last year, and that is why my budget is $56 billion higher than the defense budget.

Mr. DOWNEY. Mr. Secretary, in all due respect, I am sick and tired of hearing this administration, Cabinet officer after Cabinet officer, come up here with the chopped-liver approach to budget numbers, tell us how much you are spending and how much it has increased, and that is justification for cutting poor people off food stamps, robbing welfare mothers of any hope to get back into the stream of employment?

Just citing the statistics, Mr. Secretary, is not going to do it. Let me cite some of the statistics for you. The administration proposes cuts for 1983 in outlays of $11.7 billion. Over 60 percent of these cuts would affect means-tested programs: AFDC, food stamps, medicare, medicaid. Mr. Secretary, they are only 18 percent of all of the outlays. Is that reasonable? Is that fair?

Secretary SCHWEIKER. Well, I think one of the problems, Congressman, as you saw from my charts, is that 95 percent of my budget is set by law, by Congress, by entitlement programs. So when it is set by law and when I cannot change it through the budget process except by a statutory change, we have no recourse but to cut some areas harder than other areas.

And the point I was trying to make in my chart is that you are going to have to look at entitlement programs in the same way we have looked at categorical programs, and I think if we did that we could have a little bit more equity. There is no question that there is inequity because we have gone after the part that legally we can cut quicker, which is categorical programs.

The other programs are the ones where the growth rate is. So the way to get equity, Congressman, is to deal with the entitlement programs as well as the categorical programs. There is no question that the categorical programs have been hit harder, I agree with that.

Mr. DOWNEY. Mr. Secretary, I want to read for you parts of the testimony, because frankly we can argue the numbers all day and I think that is almost irrelevant. A few months ago a priest working

in a food center wrote: "The poor are legion, and their stories tear at your insides. The number of families seeking help has doubled what it was last summer. I really get frightened when I think what is coming this winter."

Another example, from the Archdiocese of St. Paul-Minneapolis: A woman there, knowing of the lack of adequate shelter for the homeless, left a stack of blankets in an unlocked car overnight. The next morning she found six adults sleeping inside, huddled against the cold.

So the stories go on and on and on. But frankly, the thing that bothers me the most is that in 1980 we enacted the child welfare and foster care reform program. There were four votes against this bill. This bill was basically designed to avoid unnecessary use of foster care where services to families that can prevent children from being moved home to home. And we found when we marked up that bill, Mr. Secretary, that children were remaining in foster homes year after year after year unnecessarily because the States were not doing an adequate enough job to find out where these kids were. Long stays in foster homes; no real concentrated effort to unify children and their families.

Now, the President is proposing to cut title XX by another $425 million and cut funding for the child welfare and foster care program from over $500 million down to $380 million. He is proposing to block grant and eliminate any Federal examination of State activities to determine if the goals of the program are being accomplished.

Now, we are talking about children, Mr. Secretary, who are going to remain in foster homes where the States have not done an adequate job in finding out where they are.

What does that law mean to you, Mr. Secretary? What responsibility do you have or does this National Government have for children in foster homes and children who are abused?

Secretary SCHWEIKER. All right. Let me divide my answer into two parts. First, in terms of targeting, I realize the Congressman is from New York, and I think it is interesting that in one jurisdiction in New York State, under certain circumstances, a couple earning $29,000 can still be eligible for welfare prior to the 1981 amendments. Now, to be quite honest with you, that is exactly the problem.

Mr. DOWNEY. What does that have to do with children, Mr. Secretary? I am asking you about the law, Public Law 96-296.

Secretary SCHWEIKER. Because they receive welfare under your proposal, Congressman. That is what it has to do with children.

Mr. DOWNEY. What about the kids in foster homes, Mr. Secretary? Can you not give a straight answer to a question, instead of giving us some irrelevant anecdote about some person who is too high on income? What about the poor kids?

Secretary SCHWEIKER. If you can give me a question instead of a statement, I could.

Mr. DOWNEY. I gave you a question.

Secretary SCHWEIKER. The answer is that when you put families making $29,000 a year on welfare, you do not have enough money to pay the children that you want to pay, Congressman. And it is

in your State and they are doing it, and that is what we are trying to alleviate.

Mr. DOWNEY. How many people——

Chairman ROSTENKOWSKI. Mr. Guarini will inquire.

Mr. GUARINI. To change the tone but not the meaning, Mr. Secretary, there has been some talk about health care competition which you have just alluded to in your statement. For some time we have been expecting that proposals were going to come from you to Congress. Could you give us some information and details on that? What is your timetable and how would the program work?

Secretary SCHWEIKER. We have a meeting of the Cabinet Council——

Mr. GUARINI. Would you please speak into the microphone. I think that would be helpful to everyone in the room.

Secretary SCHWEIKER. We have a meeting of the Cabinet Council on this subject today, in fact later this afternoon. So I am very hopeful that we will get a basic formulation at our policy council meeting today and present it to the President very shortly.

My guess would then be that we would get to the Congress within a few weeks after that. So I would expect within the next month we would have some very specific proposals.

Mr. GUARINI. Do you have proposals now? Would you include medicare vouchers in the proposal?

Secretary SCHWEIKER. Yes, we have three basic proposals we are looking at. One, is a medicare voucher system, another is a catastrophic plan that provides for 6-percent coinsurance feature, and the third is to give employees of employers a choice of two or three different plans, for them to choose the most cost effective plan for them. They are the three.

Mr. GUARINI. Will there be any tax increases involved in this program on the part of employers or employees?

Secretary SCHWEIKER. In terms of tax increases, no. If we go ahead with the catastrophic, if we cover people with catastrophic insurance under this option two, there would be a 6-percent cost-sharing charge for a hospital stay in return for that person getting catastrophic insurance for life. So that would be a tradeoff and I believe that is the only element that comes to mind.

Mr. GUARINI. What would be the cost-sharing by the beneficiary, just 6 percent?

Secretary SCHWEIKER. Six percent of the hospital bill per day.

Mr. GUARINI. What about physician's fees? Would there be any other fees besides just the hospital sharing involved in it?

Secretary SCHWEIKER. No, I do not believe so.

Mr. GUARINI. And the PSRO program I understand that you want to repeal, is that correct?

Secretary SCHWEIKER. That is right.

Mr. GUARINI. And the reason for that is that you feel it has not worked?

Secretary SCHWEIKER. Well, let me say this. The PSRO program has some——

Mr. GUARINI. Because I have seen it work in many places, and that is why I am surprised you want it repealed.

Secretary SCHWEIKER. It has some successes and some failures. The Congressional Budget Office, which as you know is a study

made by your agency here, says in fact we are losing something like 26 cents on every dollar we spend in our PSRO program. They say that it is not cost effective, and this was a study done not by us but by the Congressional Budget Office.

I still believe that PSRO's have a play, and I think the thing that is missing here is that PSRO's can continue under our proposal. We still will reimburse them through medicare, so they still can get paid through medicare or medicaid as long as they justify their effectiveness to the hospital. So if a hospital feels that a PSRO is doing its job, they just continue it.

Mr. GUARINI. Yet you cut $330 million off the budget in fiscal year 1983 for it.

Secretary SCHWEIKER. Because we were funding them totally federally, as well as funding them through subsidy. The subsidy is still continuing. It is the direct funding that we are eliminating.

Mr. GUARINI. So the hospitals that are using it can continue to use it in your opinion and should continue to use it?

Secretary SCHWEIKER. Yes.

Mr. GUARINI. Then you are not going to ask for it to be totally repealed?

Secretary SCHWEIKER. That is right.

Mr. GUARINI. Now, what is this intermediary utilization program that you are proposing for the private sector and for medicare?

Secretary SCHWEIKER. Well, actually this is a program that could well incorporate a PSRO.

Mr. GUARINI. Is this a substitute?

Secretary SCHWEIKER. They could utilize a PSRO to do that, and there is no reason at all—in fact, it is an encouragement for the hospital to do something in this area, and the PSRO that has proved themselves could qualify and then we would still pay the bill. I think that is a great misconception about what we are doing in PSRO's.

Mr. GUARINI. Would you comment on radiologists and pathologists in hospitals and the experiences we have had and how money will be saved. Is there any assurance that if you do limit their payment that they would not pass the money down to the patients?

Secretary SCHWEIKER. What we are doing with those two specialists is to treat them the same way we treat all other physicians. It is just for some reason back when the program got started——

Mr. GUARINI. They have a better union, so to speak?

Secretary SCHWEIKER. They would get the same treatment that all the other physicians get, 80-percent treatment.

Mr. GUARINI. And would it be conditioned on the fact that the cost is not passed down for that other 20 percent to the patient?

Secretary SCHWEIKER. Yes, it would, and that was shown in my chart.

Mr. GUARINI. Thank you.

Chairman ROSTENKOWSKI. Mr. Shannon will inquire.

Mr. SHANNON. Thank you, Mr. Chairman.

Mr. Secretary, last spring the administration suggested that we amend the disability insurance program to do some of the same things that you are now recommending for the SSI program, namely using the medical factors to determine disability and im-

posing a 24-month prognosis requirement rather than the 12-month one under the existing law.

When we had hearings on this issue last May, Chairman Pickle asked you why you were going to exclude all these people from social security disability insurance protection, and you answered him this way. You said:

> Mr. Chairman, we have a very logical and sound reason for doing exactly what we did. As I mentioned a moment ago, the disability program is part of the problem here, and this was set up typical of the way Government programs grow and expand and why we duplicate things. This was set up when we didn't have the supplemental security income program.
>
> All we are proposing is to shift from one program to the other some of the people who qualify under the present disability program. So we are not cutting them off one program as much as we are transferring them from one program to another program.

And you went on to say:

> The SSI program, supplemental security income, is means-tested, so it is an effective, efficient, humanitarian way to shift the burden out of the social welfare aspect of the social security fund and put it in a program that we now have that does come from general revenues.

Now, is your previous philosophy no longer operative or is there something I missed?

Secretary SCHWEIKER. I think there are two aspects of it, Congressman. You are correct in recounting the history of it, and I think there are two things. First, I think we still count on using the SSI program as basically what I said it was intended to do. But that does not say that, forever and a day, we would totally freeze it in terms of not making some changes.

Second, the 24-month feature that you talk about is something that is used in private industry all the time. So we are not making a tougher standard on people in SSI than applies in the private sector. You will find that private plans, private insurance, do use the 2-year criterion, not the 1-year criterion. So in fact the people who are under this program got a privilege that the other people did not get.

Mr. SHANNON. That is not exactly how you described it to us last year. The proposals that you made for disability insurance last year are the same proposals that you are now making for SSI. And Mr. Pickle's question to you was, what is going to happen to the people who are knocked off of disability insurance as a result of these proposals, and you said they would be picked up by SSI.

Now you are coming in, you are saying——

Secretary SCHWEIKER. I did not say on that case, though, Congressman. I did not say specifically on that particular point they would be.

Mr. SHANNON. Yes, you did, Mr. Secretary. You said, all we are proposing is to shift from one program to the other some of the people who qualify under the present disability program. When Mr. Pickle specifically raised the question of the prognosis requirement and the other suggestion you made, which had to do with the medical factors to be considered for eligibility, you said, well, we are going to have the SSI program out there, it is not going to have these strict requirements, and it will be able to pick up those people who are knocked off of social security disability.

Now you are coming in and you are saying you want those same strict requirements applied to the SSI program.

Secretary SCHWEIKER. Read my statement again.

Mr. SHANNON. You said:

> All we are proposing is to shift from one program to the other some of the people who qualify under the present disability program. So we are not cutting them off one program as much as we are transferring them from one program to another program.

The question that was asked was, why are we going to have these strict requirements in social security disability. And you said, because the same people will be picked up by SSI, which would not have these strict requirements. And now you are saying you want to have the same strict requirements on the SSI program.

Secretary SCHWEIKER. Well, Congressman, you read my statement accurately and what I said was some, some, some. I did not say "all." I said some of the people will be in fact picked up by it. The point is we are targeting, and we knew that. I said that. I did not say all of them would be picked up.

Mr. SHANNON. The question had to do with the specific people who would be knocked off the rolls because of the changes you had proposed last year, which had to do with the prognosis period, the prognosis requirement in the disability program, and it had to do with the application of medical and not vocational factors.

Would any of those people be picked up under the SSI program if those same criteria were now applied to the SSI program? Of course not.

Secretary SCHWEIKER. It depends whether they have a 36-month disability or a 12-month disability. The 36-month people will get SSI.

Mr. SHANNON. If you apply the same criteria that you requested for disability last year to SSI, you will be eliminating the same people from SSI this year that you proposed be eliminated from disability last year. And you will not in fact be shifting them from one program to another, as you said that you would. And that is a cause of grave concern to me.

You know, you guys keep on coming up here and saying, well, we are just shifting from one program to the other, and if they are not eligible for one program they will be eligible for another. And you keep on coming back and making those same people ineligible. And I do not think that we can let you get away with that.

Secretary SCHWEIKER. Well, let me say, we did not get away with anything. I said some of the people, I didn't say all of the people. That is the very point I have been trying to make. You keep reading it back to me that way and that is what I said.

And what I am getting at is, we know that the air traffic controllers are a very good case in point. If they qualify for a disability, it is because they have mental stress, et cetera, in their job. Under the older definition, if they qualify in this situation we pay them a disability whether they can go out and do another job or not, because they cannot be reemployed in their same job as air traffic controller.

I personally think that is wrong. I do not think we owe everybody a slot for life in one particular specialty, and I think if he is not able to do that specialty but can do some other specialty we

should not have to pick up the bill. And I do not think you really mean that, Congressman, do you? That is what we are getting at here.

Mr. SHANNON. I do not know how the air traffic controllers worked their way into this.

Secretary SCHWEIKER. Because that is exactly where the abuse is. That is the definition.

Mr. SHANNON. We cannot have an administration that administers by anecdote, and we are not going to legislate by anecdote. Your testimony stands and you are contradicting that testimony coming here today.

Secretary SCHWEIKER. Not at all. We are changing the definition of it, no question, for the better.

Chairman ROSTENKOWSKI. Mr. Archer will inquire.

Mr. ARCHER. Mr. Secretary, I just have one question for you. There are a number of us on the committee who feel that the social security problems have gotten unfortunately enmeshed with the overall budgetary problem, and feel that really our major goal in the social security field is to save social security as a viable institution, not just for the next 2 or 3 or 5 years, but for the long term.

And with that in mind, in order to try to separate out some of the rhetoric that has come into this issue, we are attempting to remove social security from the unified budget and have it back where it was before Johnson put it in the budget so he could spend more and say he was not deficit spending by using the social security assets to offset spending out of the general treasury.

And I wonder if you could tell us what your view would be of this, this effort on our part to separate social security out from the budget and have it as a separate item and not considered in the overall budget of the United States.

Secretary SCHWEIKER. Congressman, at this point all I can give you is a personal opinion. I would not be able to tell you what the Government-wide position is on it, so with that caveat, I would have no objections to doing that. I think that would help us to bring focus on the problem and to look at it fairly.

I know people on both sides have advocated that and I personally feel that way, but I want to make it very clear that my answer is not necessarily the answer that the Government has on it at this point. I am not sure what their answer will be.

Mr. ARCHER. Thank you very much.

Chairman ROSTENKOWSKI. Mr. Bailey will inquire.

Mr. BAILEY. Thank you, Mr. Chairman.

Mr. Secretary, I have some of the same problems but in a different way that perhaps Mr. Shannon does, and Mr. Downey. One of the problems that I have is that when we had Mr. Stockman and yourself up testifying initially, you were testifying on the cost effectiveness of the programs. One of the major initiatives that you wanted to achieve in your transfers, and I think it is a laudable goal, was to effect a more cost-effective, cost-benefit relationship in programs.

Let me cite one very small example for you, the Bureau of Vocational Rehabilitation, that helped the States locate individuals who were on disability, get them trained, give them therapy, get them back into the work force. When the block grant proposals came

through, with the help of Mr. Pickle and others we were able to get some amendments in that you folks agreed to that set up sort of a bonus program on the part of the States.

That is an example. Those programs basically have been lost. The effect on the taxpayer is that a program that returns $1.38 for every dollar invested in it is essentially lost.

Now, the general question is this. Have you analyzed the cost-effective nature of the transfer of programs under block grant, et cetera to the States? We know that it is a theoretical idea. I have made inquiries concerning the Government percentage of gross national product devoted to those programs, netting, taking into account the block grant transfers, and most of the arithmetic comes out that we have not saved the taxpayers a cent. We have taken the obligations, basically, from one tax base and we have put that obligation on another tax base.

Do you have something that can controvert that? I know it is politically, to get it closer to home and the States are going to administer it better, but certain target groups, Stockman testified, will be kept in the Federal arena because the States will not efficiently be able to locate those target groups.

What is the GNP relationship? Have you studied that?

Secretary SCHWEIKER. Congressman, let me say that this is an obviously debatable issue, and what we had initially was some estimates that obviously were estimates. Because the program only began effectively the 1st of October and because there is a delay in the funding mechanism and then an accounting mechanism, we really wouldn't have any valid data to answer your question, but we will be answering it.

Mr. BAILEY. Would you, please, because I will tell you what I suspect, and I am not blaming you or pointing a finger at you, by the way. I have known you for a few years and I respect you, and I know that you, at least in dealing with some of your politics, have tried to do something to help some of these target groups, although we don't agree on everything.

What it looks like is happening is that the New Federalism concept is just being used as a way to, first of all, balance the Federal budget and get rid of the national problems or the administration's problems; and No. 2, that it is another part of what I view as a broad plethora of income transfer schemes that will place increasing burdens on middle and lower income taxpayers, will decrease services and will not do a damn thing to lower that governmental percentage or involvement out there in the Nation's gross national product.

Now, if that is true, it is a heck of a political idea but it is an effective fraud on providing goods and services to people that we all acknowledge need them. I would invite your comments on that. But on this question of efficiency, I do not think you have made a believer out of anybody yet and I do not see any efficiencies. I have talked to State government people. Where have you gained a thing? Where have you delivered a better service? I know it is new, but can you put your finger on a program that is improved that way?

Secretary SCHWEIKER. Congressman, I think you are right in terms of not having hard statistics at this point. As I mentioned a

moment ago, we are going to get it and get back to you when we have some experience to base it on and try to be very objective about it. I would like to answer your question, though, about New Federalism because I think we could answer it in two ways.

No. 1 is that there is no question that we made some cutbacks to the States in last year's budget and in this year's budget, no question about that, and we acknowledge that. On the other hand, I was with the Governors and the President last night, and the President reiterated again that in the New Federalism concept he is not going to have any winners and losers and we are not going to do that kind of cost cutting.

So I just want to assure you that in the New Federalism concept, that is not the fundamental precept that we are working on. I would strongly oppose it if we were because, first of all, I don't think the States will buy it. Second of all, I think we are going back on what the President wanted to do, and I agree with you that there is concern here that we don't do it because the program will fail if we don't do it.

Mr. BAILEY. If you try to fund it with the tax schemes you are suggesting, including that trust fund based on excise taxes, et cetera, and you look at the income-transfer mechanism and you look at the respective tax bases involved, State and Federal, you are backing way up. It is not going to work, Mr. Secretary. I think you are going to end up with an abysmal failure.

Secretary SCHWEIKER. We made it clear, Congressman, that that is a very negotiable point.

Mr. BAILEY. It is going to have to be.

Secretary SCHWEIKER. Unless you can give the States some guarantee of some incomes in the future, the program will not work. So I would agree that we have to produce a solid basis for that.

Chairman ROSTENKOWSKI. Mr. Secretary, you served on the Hill for about 12 years, didn't you?

Secretary SCHWEIKER. It was 20, counting the House and Senate together, right.

Chairman ROSTENKOWSKI. Did you ever write a letter to a department and expect an answer on a certain date and not get it?

Secretary SCHWEIKER. It would get me a little upset.

Chairman ROSTENKOWSKI. You have a handsome and quite a large staff there, Mr. Secretary. I asked you to give me some answers to the administration's program. I asked that they be submitted to the Committee by February 22. When can I expect answers to those questions? I wrote you a letter on February 16, Mr. Secretary, and asked you to respond by midnight of February 22 so that we could have them for this hearing. I would like to know when you will answer them, that is all.

Secretary SCHWEIKER. Well now, Mr. Chairman, I certainly respect that the chairman ought to get answers quickly and respond, but we honestly did not get that letter until the 18th of this month. It was dated the 16th. We did not receive it until the 18th at 2:53 p.m., because we do date stamp them.

Chairman ROSTENKOWSKI. Well, Mr. Secretary, I am not going to get into an argument with you about that. It was hand carried over to your office on February 16. When can I get some answers? That is all I want to know.

Secretary SCHWEIKER. I did give you a letter. I guess you did not see it, but I did give you a letter, as a matter of fact, responding to it yesterday, which was an interim and did not have the material you wanted, but we did promise it to you at that time by February 26.

Chairman ROSTENKOWSKI. I just wondered when we were going to get it, Mr. Secretary.

Secretary SCHWEIKER. Let me say we tried to respond very instantly to the chairman, but a lot of material was requested in that letter.

Chairman ROSTENKOWSKI. Well, it is customary that before we engage in exchanges, that we know a little bit about what the administration is suggesting. These were questions that were raised by what we saw as an outline of the administration's request. So if you could get it to us, we'd appreciate it.

Secretary SCHWEIKER. Yes; I think one thing that might be helpful, Mr. Chairman, usually when we get a letter we get a whole laundry list, and there is no objection to that, but if the Chair would tell us which several items he would like to focus on, we could break it out and maybe be a little more responsive, instead of trying to answer the whole ball of wax in 3 or 4 days, that is all.

[The letter and subsequent response follow:]

COMMITTEE ON WAYS AND MEANS,
U.S. HOUSE OF REPRESENTATIVES,
Washington, D.C., February 16, 1982.

Hon. RICHARD S. SCHWEIKER,
Secretary, Department of Health and Human Services,
Washington, D.C.

DEAR MR. SECRETARY: The President has made many important legislative recommendations which fall within the jurisdiction of the Committee on Ways and Means. By close of business on February 22, we would appreciate receiving responses to the enclosed questions.

These answers are necessary for the Committee to act in an informed and responsible manner. If your staff has any specific questions about the details, please contact Committee staff. Your prompt attention to this request will be greatly appreciated.

With warm regards, I am,
Sincerely yours,

DAN ROSTENKOWSKI,
Chairman.

[Enclosed questions are repeated in answering letter.]

THE SECRETARY OF HEALTH AND HUMAN SERVICES,
Washington, D.C., February 26, 1982.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, U.S. House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: This is in reference to your letter dated February 16, 1982, and which I received on February 18, requesting answers to a number of questions on the President's Fiscal Year 1983 Budget.

As I mentioned in my interim response of February 23 and also in our discussion during Wednesday's hearing, I am enclosing the resposes to your questions.

With every good wish.
Sincerely,

RICHARD S. SCHWEIKER,
Secretary.

Enclosures.

1. AFDC/CSE

Question a. What are the estimated savings for fiscal year 1982-1987 for *each* of the proposed changes?

Answer. The following two tables show savings for the proposed changes in the AFDC and CSE programs.

SUMMARY OF SAVINGS BY PROVISION

[In millions of dollars]

AFDC	Fiscal year—					
	1982	1983	1984	1985	1986	1987
A. Strengthen work requirements:						
Mandate CWEP projects	−6	−49	−82	−70	−70	−71
Require CWEP for principal earners	−23	−86	−79	−73	−70	−68
Mandate job search	−35	−145	−149	−152	−156	−159
Sanction voluntary quit—WIN exempt	(1)	−1	−1	−1	−1	−1
B. Count income and resources:						
Redefine assistance unit and its income						
Count income of unrelated adults	−20	−69	−70	−70	−72	−73
Include parents and all minor children except SSI	−16	−63	−64	−64	−66	−67
Remove caretaker's needs when youngest child 16	−12	−47	−48	−48	−49	−50
Count energy assistance as income	NA	−175	−175	−175	−175	−175
C. Target assistance:						
Exclude military absence as a deprivation factor	−4	−16	−17	−17	−17	−18
Prorate shelter and utilities	−45	−174	−177	−178	−182	−186
D. Improve administration:						
Prorate first month's benefit	−3	−14	−14	−14	−14	−14
Round need and payment amounts to lower dollar	−2	−10	−10	−10	−10	−10
Consolidate welfare administration costs	NA	−40	−89	−137	−181	−223
Phase in zero error tolerance	NA	−234	−105	−167	−237	−244
Total	−166	−1,123	−1,080	−1,176	−1,300	−1,359

[1] Less than $1 million.

Note.—All provisions are effective July 1982 with exception of count energy assistance as income—November 1982. Consolidate welfare administration costs—November 1982. Phase in zero error tolerance—November 1982.

CSE SAVINGS BY PROVISION

[Savings in millions of dollars]

Provision	Fiscal year—					
	1982	1983	1984	1985	1986	1987
1. Restructure funding of the program	25	100	100	100	100	100
2. Require States retain 6 percent fee for non-AFDC cases	10	45	51	59	66	76
3. Increase collections:						
Require military personnel to make allotments		7	9	10	10	10
Require military personnel to be present at hearings		1	1	1	1	1
Allow food stamp agencies to disclose information from records for CSE program purpose		1	1	1	1	1
Eliminate double payment received by AFDC families when they become ineligible for continued assistance because of child support		3	4	4	5	5

AFDC

Question b. What is the number of individuals and families who will lose or gain benefits by provision and the number who will experience a reduction in benefits, nationwide and by State, as a result of all proposed changes?

Answer. The attached table shows the estimated number of households affected by the provisions nationally.

We are not providing state by state estimates because we cannot be reasonably confident of their reliability. The small size of the state samples in the national model, reduced further to adjust for the effect of the 1981 AFDC changes may yield insufficient precision in estimates at the state level. We are addressing this question of sample reliability by tracking state savings achieved from AFDC changes and comparing them to original federal estimates. However, it is premature to make an evaluation of the accuracy of state level estimates.

1. Table of households affected.—

THE ESTIMATED EFFECTS ON HOUSEHOLD ELIGIBILITY AND BENEFIT LEVELS

	Ineligible	Reduced	Increased
Count income of unrelated adults	41,000	2,000	.....
Exclude military absence as a deprivation	10,000	.....	.....
Include parents and all minor children except SSI	28,000	74,000	.....
Remove parent's needs when youngest child is 16	1,000	142,000	35,000
Prorate shelter and utilities	14,000	459,000	.....
Total	94,000	677,000	[1] 31,000
Rounded	100,000	700,000	30,000

[1] Reduced because of interaction with other proposals.

2. Mandate job search.—An estimated 150,000 will be diverted from welfare because of the requirement that they actually look for a job. This provision will help ensure that those who can and should rely on earnings from private employment will obtain jobs.

3. Round need and payment amounts to lower dollar.—A large, but unknown, number of recipients will lose a small amount of benefits because of rounding down. On the average, the reduction will be only 50 cents per month. A similar action was enacted last year for Social Security and the FY '83 budget contains similar proposals for SSI, VA Compensation and Pension, Federal Retirement, Food Stamps, and Unemployment Compensation Programs.

4. Prorate first month's benefit.—An estimated 16,000 families per month will have their first months benefit prorated based upon actual date of application, rather than receiving benefits for a period when not in need. Similar actions were enacted last year for Social Security and Food Stamps, and the FY '83 Budget proposes similar measures for SSI and VA Pension programs.

5. Count energy assistance as income.—An unknown number of recipients will lose the double payment they now receive for energy costs. This will ensure that sources of income are fully counted for AFDC.

AFDC

Question c. What is the impact upon food stamp and Medicaid costs resulting from each of the proposed AFDC changes?

Answer. The estimated increase in federal Food Stamp costs that would result from the AFDC changes is:

Fiscal year:	*Millions*
1982	+$79
1983	+436
1984	+447
1985	+439
1986	+440
1987	+442

The total additional Medicaid savings resulting from the AFDC changes are:

Fiscal year:	*Millions*
1982	−$34
1983	−153
1984	−170
1985	−190
1986	−210
1987	−230

Both the Food Stamp costs and the Medicaid savings have been included in the President's budget. Because of the complexities of the interactions between the various AFDC provisions and the Food Stamp program, we are not able to break out accurately these additional Food Stamp costs or Medicaid savings provision-by-provision.

Question d. Describe the methodology and major assumptions used in estimating savings from the following three provisions: a community work experience program, a mandatory job search, and provision of UP benefits only if parent participates in workfare. What are the increased administrative costs from each of these provisions?

Answer.

MANDATE CWEP PROJECTS

Savings for this provision are based on the assumption that mandatory CWEP will result in a percentage of cases moving from AFDC being diverted from dependence on. Rather than relying on public assistance, individuals who can and should will have a greater incentive to find private employment. In a Food Stamp demonstration project the deterrence factor was found to be about 28 percent. This was reduced by half to keep our estimate conservative.

Although we have not included savings from increased employability of AFDC recipients who gain skills through participation in Community Work Experience Programs, we expect that this factor would increase savings significantly. The value of work performed in local communities has also not been included in this budget, even thought it may be substantial.

The savings estimates are net savings of the mandatory program over already projected savings for the optional program. This interaction is responsible for the apparent savings reduction in fiscal year 1985. The savings attributable to the mandatory provisions themselves does not decrease. However the net figure (mandatory over optional) does decrease because the savings projected for current law optional CWEP increase sharply in that year as States develop more comprehensive programs.

REQUIRED CWEP FOR PRINCIPAL EARNERS

These savings are based on the same assumptions as the provision to mandate CWEP projects especially in two-parent families, the principal earner should rely on income from private employment rather than welfare. Unemployed parent caseload under current law was multiplied by the same 14 percent deterrence factor, then by the projected average grant for each year, yielding annual savings. The out-year estimates decline under the assumption of declining future unemployment.

MANDATE JOB SEARCH

This estimate was based on information derived from Oregon's Job Search program. Savings are attributed to the expectation that job search diverts a percentage of initial applicants from actually attaining payment status. The Oregon Job Search program found that 10 percent of all applicants were able to obtain employment through the program and/or did not seek AFDC when faced with the job search requirement.

Because of its emphasis on work programs including mandatory job search, Oregon's caseload has decreased, even at a time of high and rising unemployment (11.7 percent in December 1981). In Michigan's Kent County, where unemployment is high, twenty percent of its job search participants have found jobs.

ADMINISTRATIVE COSTS

The three provisions to mandate CWEP projects, CWEP for principal earners, and job search leave a great deal of flexibility to the States with respect to the kinds of activities and their associated costs that are undertaken. This flexibility makes it impossible at this time to accurately estimate the administrative, costs associated with these provisions. We believe, however, that the program savings that will be realized by these provisions, reduced administrative costs due to lower case loads and the savings to States from the increased flexibility of the Combined Welfare Administrative Block Grant will offset these administrative costs.

Question. e. Why would States continue to provide low-income energy assistance benefits to AFDC families rather than other low-income families?

Answer. We expect most states that currently pay energy assistance benefits to AFDC recipients will continue to do so. In many states the energy assistance benefit

will exceed the amount for energy implicit in the AFDC payment standard. Therefore, since AFDC benefits are reduced only by the amount of the implicit heating and or cooling payment embodied in the AFDC benefit, households may still receive a net increase in assistance because of the energy assistance payment. Since AFDC households would be better off with the energy payment than without it, we expect states to continue making energy assistance payments to AFDC recipients.

Furthermore, energy assistance programs allows states to target assistance more effectively in three ways: 1) vendor payments ensure the benefit is used for its intended purpose; 2) energy program benefits can be better tuned to household energy needs (e.g. type of fuel used, climate); 3) program benefits can vary from year to year based on the severity of the weather.

Question f. Describe in detail and by example the proposals to prorate shelter and utilities for AFDC families in large households, to include income of all unrelated adults and to include all minor children. What guidelines will be given to the States in determining how much of their need standard is for utilities and shelter? To what extent will potential savings from these provisions be offset by changes in family composition?

Answer. We propose to reduce the amount paid for shelter and utilities to AFDC units sharing a household with other individuals. The assistance unit would receive the amount determined by multiplying the amount that would be paid for shelter and utilities to an assistance unit that includes the total number of household members, by the ratio of the number of individuals in the assistance unit over the total number of household members.

There would be no guidelines in the statute regarding how States should determine what part of their need standards are for shelter and utilities. Under current regulations on counting the value of housing subsidies, States with a flat-grant system must estimate the amounts based on historical data or other justifiable procedure. We expect to have the same requirement under this provision.

In a State that pays $150 for shelter and utilities to a 3-person assistance unit and $220 for shelter and utilities to a 5-person assistance unit, where a 3 person assistance unit lives with 2 other individuals the State would multiply $220, the shelter and utility allowance for 5 persons, by 3/5, the ratio of persons in the assistance unit to persons in the household.

The State would pay the assistance unit $132 for shelter and utilities.

REDEFINITION OF ASSISTANCE UNIT

Our proposal would require inclusion of parents and minor siblings of an AFDC child in the assistance unit. Thus, the State would consider both the income and needs of the parties and minor siblings, except where they are receiving SSI. Stepbrothers and stepsisters would not be included if the stepparent lives in the same home, and is not seeking assistance, because the needs and income of his or her children would have already been considered under the stepparent provision.

All employable caretaker relatives (parents and non-parents) would be excluded from the unit when the youngest dependent child is 16. Employable caretaker relatives would be those who are not exempt from WIN registration. (The exemption for remoteness from a WIN site would not apply.)

Example.—Under current law, the parent of an AFDC child living in a household with a minor sibling may choose to exclude the sibling from the assistance unit. This would be to the child's advantage where the sibling has income, for example, from child support payments or Social Security benefits. Under our proposal, the State must include the sibling in the assistance unit (except if he is receiving SSI) and count his income.

COUNTING THE INCOMES OF SPECIFIED MEMBERS OF THE HOUSEHOLD

We propose to require the States to count the incomes of certain individuals in the household who are not included in the assistance unit. Their income would be counted after applying the same disregards which currently apply to the income of stepparents. These individuals are:

The employable parent after the youngest dependent child reaches age 16.

The parent(s) of the caretaker relative if the caretaker relative is a minor, but only if the parent(s) is living with the minor caretaker relative and is not included in the assistance unit, and

Any unrelated adult living in the same home with the dependent child and his parent (other than a tenant paying the full value of room, or room and board).

Individuals receiving assistance based on need would not be covered by this part of the provision.

Example.—If a minor mother who lives with her parents applies for assistance for herself and her child, the State would count the income of the parents after applying the current stepparent disregards, unless the parents are receiving assistance based on need such as SSI or general assistance.

EFFECT OF THESE PROPOSALS ON FAMILY COMPOSITION

We have no information to indicate that family composition will be affected by these provisions, and therefore have not included any offset to the savings. We are conducting an evaluation of the '81 changes in order to answer analogous questions with respect to that legislation. Should the administration's new proposals become law, we would expect to conduct an in-depth evaluation of these provisions also.

Question g.—For the administration block grant, please describe this proposal in greater detail. Exactly how much will each State receive in the 1983 to 1987 period assuming the new federalism program is not enacted. How much would each State receive under current law? What are the average administrative costs for food stamps, AFDC and Medicaid per household by State under current law?

Answer. The combined welfare administration block grant would make a single payment to each state for the on-going expenses of administration AFDC, Medicaid and Food Stamps. Many burdensome and overlapping requirements will be removed thus giving the States both the ability and the incentive to administer efficiently public assistance programs. For example, State matching funds would no longer be required.

Details on the allocation formula for Combined Welfare Administration block grant are still being specified. Thus, it is not now possible to say how much each state will receive under the block grant. Attached is a table that projects what each state is expected to receive in fiscal year 82 for each program under current law. No estimates are available for subsequent years. A table listing average administrative cost per household for AFDC in each state for a recent period is also attached. Similar data for Food Stamps and Medicaid are not available.

FEDERAL SHARE OF ESTIMATED ADMINISTRATIVE COSTS, FISCAL YEAR 1982

[In thousands of dollars]

State	AFDC	Food stamps	Medicaid [1]
Alabama	$8,128	$13,884	$7,790
Alaska	2,251	4,429	1,611
Arizona	7,719	9,636	6,740
Arkansas	3,757	7,714	152,256
California	176,808	48,282	6,662
Colorado	6,682	3,616	12,178
Connecticut	7,272	3,864	1,465
Delaware	1,750	1,458	6,277
District of Columbia	7,667	2,676	22,576
Florida	21,249	17,761	17,134
Georgia	16,543	15,155	100
Hawaii	3,421	2,239	3,400
Idaho	3,220	1,661	3,480
Illinois	44,173	15,460	34,633
Indiana	10,946	6,302	11,132
Iowa	7,742	4,448	6,304
Kansas	4,852	2,733	5,050
Kentucky	10,849	13,470	11,747
Louisiana	14,367	17,539	13,072
Maine	2,253	2,044	4,672
Maryland	8,170	11,409	12,647
Massachusetts	26,513	7,881	22,237
Michigan	66,178	20,024	38,612
Minnesota	14,234	5,720	15,706
Mississippi	4,897	15,273	7,437
Missouri	13,186	9,292	7,905
Montana	1,858	1,102	2,994
Nebraska	3,663	2,209	5,359
Nevada	2,044	2,079	1,957
New Hampshire	1,556	2,106	3,058

FEDERAL SHARE OF ESTIMATED ADMINISTRATIVE COSTS, FISCAL YEAR 1982—Continued

[In thousands of dollars]

State	AFDC	Food stamps	Medicaid [1]
New Jersey	31,960	6,271	28,704
New Mexico	4,203	5,164	3,897
New York	146,034	57,495	170,966
North Carolina	10,262	13,244	177,298
North Dakota	1,100	769	3,094
Ohio	38,101	18,774	29,528
Oklahoma	11,623	7,890	19,866
Oregon	10,752	6,146	13,037
Pennsylvania	68,711	23,901	42,784
Rhode Island	3,279	1,372	3,769
South Carolina	4,873	9,468	7,939
South Dakota	1,505	2,146	1,634
Tennessee	9,691	15,488	12,340
Texas	26,525	37,265	59,025
Utah	3,702	1,917	5,135
Vermont	1,529	944	4,119
Virginia	14,953	8,222	12,330
Washington	16,277	16,934	15,192
West Virginia	3,025	4,455	6,963
Wisconsin	17,083	2,647	24,228
Wyoming	668	1,010	487

[1] These estimates do not reflect savings incorporated in the 1981 Budget Reconciliation Act.

AFDC administrative cost per case by State, 1980

State:	Cost
Alabama	$18.30
Alaska	38.55
Arizona	36.46
Arkansas	17.09
California	45.44
Colorado	27.19
Connecticut	18.98
Delaware	18.32
District of Columbia	26.85
Florida	30.18
Georgia	24.19
Hawaii	21.81
Idaho	48.92
Illinios	30.89
Indiana	28.53
Iowa	22.48
Kansas	29.87
Kentucky	23.92
Louisiana	28.54
Maine	17.25
Maryland	15.76
Montana	28.62
Michigan	30.66
Minnesota	29.59
Mississippi	8.86
Missouri	29.60
Montana	31.89
Nebraska	39.40
Nevada	52.26
New Hampshire	23.90
New Jersey	31.56
New Mexico	30.46
New York	55.52
North Carolina	18.43
North Dakota	31.38

AFDC administrative cost per case by State, 1980—Continued

State—Con.	Cost
Ohio	23.66
Oklahoma	36.55
Oregon	42.73
Pennsylvania	38.55
Rhode Island	21.60
South Carolina	19.50
South Dakota	32.16
Tennessee	22.98
Texas	32.19
Utah	34.48
Vermont	26.05
Virginia	29.82
Washington	36.18
West Virginia	18.95
Wisconsin	14.06
Wyoming	42.26

2. SSI

Question a. What are the estimated saving for fiscal years 1982-1987 for each of the proposed changes?

Answer:

[Budget authority in millions]

	Fiscal year—					
	1982	1983	1984	1985	1986	1987
24-month prognosis for disability	−5	−45	−85	−130	−170	−200
Preponderance of medical factors	−10	−75	−145	−240	−335	−420
$20 disregard		−15	−75	−120	−160	−200
Proration	−10	−40	−40	−40	−40	−40
Rounding	−3	−20	−45	−75	−105	−135
COLA coordination	−50	−45	−45	−40	−40	[1] −40
Hold-harmless	−23	−30	−37	−45	−45	−45
Pass-through	0	0	0	0	0	0
Recovery of SSI overpayments	0	−16	−17	−18	−19	−20

[1] These savings figures are for the proposed amendment only. As the law now stands, retrospective accounting would cost $40 million in the first three years (1982-1984). The proposed amendment restores the saving of $20 million in 1982 and $40 million in each of the outyears, which were projected when the provision was enacted as part of the omnibus Budget reconciliation Act of 1981.

Question b. What is the number of individuals who lose benefits by provision in fiscal year 1983 and fiscal year 1984?

Answer. Some of the SSI proposals will have no direct impact on the benefits of recipients. The proposal to round benefits to the next lower dollar will affect all recipients, but the impact will be negligible on any individual benefit check. The proposals which will have an effect on benefits are listed below, with estimates of how many individuals (in thousands) will be affected:

	Fiscal year—	
	1983	1984
24-month prognosis for disability	35	60
Preponderance of medical factors	80	135
Eliminate $20 disregard	300	675
Prorate first month's benefits	550	550
COLA coordination	1,665	

[1] 1,620 Figures for this proposal are based on an estimate that the proposal would affect 45 percent of the total Federal SSI caseload.

3. Child Welfare

Question a. What reduction in services or assistance will take place as a result of the reduced funding? How many and which individuals will be affected by the loss in funding?

b. How will allocation to the States be made under the block grant?

Answer. The draft Child Welfare Block Grant legislation is currently being developed within the executive branch and we expect it to be available to Congress in mid-March. Until final specifications are available, I can not state the actual allocation method to be proposed though I anticipate that it will be modeled after the Social Services Block Grant which allocated funds based on the distribution in a prior year (in this case FY 81). We are unable to estimate the totals in the number and types of services because, under the new law, states would have the discretion to distribute funds among authorized services areas.

4. Social Services Block Grant

Question a. We believe that the removal of excessive administrative requirements under the Social Services Block Grant will free States to use these funds as efficiently as possible for the population in need. What reduction in services or assistance will take place as a result of the reduced funding? How many and which individuals will be affected by the loss in funding?

Answer. Because Social Services Block Grant reduces the reporting requirements on the states, and because we have only five months of experience with the Block Grant, we are unable at this time, to estimate the reduction in services as a result of the proposed reductions. In addition, we can not say what the totals in the numbers of individuals and types of services will be because states have discretion in distributing these funds for the various authorized services.

5. Medicare

A. PROPRIETARY RECEIPTS FOR SMI

Question. In this budget, Medicare outlays (and budget authority) have been reduced by the amount of Medicare premiums. Recognizing that "proprietary receipts" are accounted for in this fashion for some other domestic programs, why, after 15 years of experience, was it felt necessary this year to adopt this accounting convention for Medicare?

Answer. There are two kinds of receipts included in the Federal budget. The first is what is known as "governmental receipts," such as revenue from the income tax of the Social Security tax, which are derived from the general taxing authority of the Federal government. In the case of the Social Security tax, this revenue is shown in the budget as income to the Social Security and Medicare Trust Funds. The second type is "proprietary receipts," which, in general represent voluntary payments to the Federal government in exchange for something of value. These receipts are shown as offsets to outlays and budget authority in the budget.

In the past, premiums paid by enrollees in the Medicare Supplementary Medical Insurance (SMI) program were treated as "governmental receipts" primarily because of the program's close association with the Medicare Hospital Insurance (HI) program, which is financed by a portion of the Social Security tax and which is also treated as "governmental receipts." However, since SMI coverage is purely voluntary and the premium is paid in exchange for immediate medical insurance coverage, OMB decided to treat revenue from the SMI premium as a "proprietary receipt," which more accurately reflects the true nature of this income.

B. MEDICARE COVERAGE FOR FEDERAL EMPLOYEES

Question. To compensate for increased personnel costs arising from this proposal, what adjustments, if any, will the Federal government make in the FEHB program or in salary or other fringe benefits of Federal employees? What transitional provi-

sions, if any, are proposed with respect to Federal employees who will reach age 65 (or become disabled) without sufficient time to acquire Medicare Part A insured status through Federal employment?

Answer. The legislative proposal to extend Medicare coverage to Federal employees will require Federal employees to pay the Medicare Hospital Insurance portion of the Social Security tax with matching payments to be made by Federal agencies. At the present time, OMB has determined that all Federal agencies will be required to absorb the employer share of the tax within their fiscal year 1983 budget requests.

With respect to changes in the FEHB program, the Office of Personnel Management is studying options for reform of the current insurance program for Federal retirees in light of the Medicare proposal. The introduction of "wrap-around" coverage that would supplement rather than duplicate Medicare coverage will be a major focus of this study.

Finally, the Administration is reviewing the question of alternative transitional arrangements for Federal employees who would not be able to qualify for Medicare coverage because of age. A decision on the matter is expected very soon and will be incorporated in the legislation forwarded to Congress. It should be noted, however, that the outlay impact of possible transitional arrangements has not been included in the fiscal year 1983 budget since final decisions were not available at the time the budget was submitted to Congress in early February.

C. WORKING AGED

Question. Does the working aged proposal apply to non-profit and government employers? What enforcement mechanism exists for such employers?

Answer. The proposal is intended to apply to all employers. Although we have not requested sanctions to apply specifically to non-profit and government employers who do not comply with the non-discrimination provisions of the proposal, we have not ruled out seeking additional legislation to deal with noncompliance among such employers, if necessary.

Question. What effects do you expect the working aged proposal to have on employment of the elderly? Will the effects differ for large and for small employers? What will the effect be where employees pay a share of the premium costs?

Answer. The working aged represent less than one-half of one percent of the work force. Thus, the cost impact of this proposal on the employer is not expected to be significant and we anticipate that the proposal's effects on employment of the elderly will be minimal. Employees with a very small work force may have few older workers to begin with. Further, most small employers do not provide comprehensive health insurance programs, so we expect this proposal to have negligible effect in that respect.

Since any increase in premium costs will be spread throughout the whole employer group, the impact on individual employers will be negligible.

D. HOME HEALTH COINSURANCE

Question. How will the 5 percent coinsurance be calculated (as a percent of what figure)?

Answer. The details of this proposal are still under discussion and will be made available as soon as final decisions are reached.

E. PHYSICIAN REIMBURSEMENT

Question. What changes in the rate of physician acceptance of assignment do you anticipate this year and in the future as a result of the postponement of the annual fee screen up-date and the one-time "hold-down" in the economic index?

Will the one-year action on the latter affect prevailing charges in future years?

Answer. Since these proposals are expected to have minimal effect on actual fee levels, they are not expected to significantly affect the assignment rate.

For example, the proposal to limit the economic index rate of increase to 5 percent means that the maximum that a prevailing charge that was $100 in the previous year could increase would be $5 instead of $7.80.

A limit on the rate of increase (and not an actual reduction in reimbursement levels) of this magnitude is not expected to have a significant effect on assignment rates.

The growing supply of physicians should have competitive effects which increase the willingness of physicians to accept assignment.

This one-time limit on the rate of increase would affect prevailing charges in future years as there would not be a catch-up from this limitation.

It should also be noted that physicians are among the highest paid professionals in this country. The average income of physicians is about three and one half times that of the average family's income. In addition, evidence demonstrates that in relation to other professionals, the rate of return to physicians from medical education is one of the highest. Small contributions by our country's medical professionals toward fighting the ravaging effects of spiraling inflation in our nation are justified.

F. EIGHTY PERCENT RADIOLOGY AND PATHOLOGY RETURN

Question. What is the anticipated effect on Medicare assignment rates in the field of radiology and pathology? What has been the experience, in terms of acceptance of assignment, under the recently enacted provisions of current law that permit 100-percent reimbursement only where the radiologist or pathologist agrees to accept assignment in all cases?

A. This proposal would not reduce reimbursement levels to radiologists and pathologists; it would only change the sources of the reimbursement. Medicare would reimburse 80 percent of reasonable charges (the same as Medicare reimburses for services of all other physicians). The beneficiary would be responsible for the 20 percent coinsurance. The physician would have to collect from the two sources but the ultimate amount receivable would not be changed.

Historically, radiologists and pathologists who bill directly have had assignment rates higher than the national averages.

[In percent]

	1975	1976	1977
National average	47.2	47.2	48.4
Radiologists	52.8	58.4	56.4
Pathologists	60.5	60.2	61.5

(Radiologists and pathologists whose services were billed on a combined bill are excluded from these data. The assignment rates are based on charges for claims submitted and thus national figures differ slightly from a measure based only on a count of claims.

On the basis of this historical experience adverse effects on the assignment rate from this proposal should not be expected.

There is a large variation in the percent of radiologists and pathologists who signed assignment agreements. It is hard to identify the effects of Section 943 because there is little state-by-state baseline data to which these data can be appropriately compared.

G. UTILIZATION REVIEW INITIATIVE

Question. NCFA/private sector utilization review initiative: To understand better how it is proposed to reduce Medicare fiscal year 1983 spending by $330 million, the Committee would appreciate having detailed information about this proposed regulatory initiative.

A. This current law initiative will give Medicare contractors greater responsibility for identification and reduction of unnecessary utilization of health care services provided to Medicare beneficiaries as the PSRO program is phased out. A strategy for implementing this program is currently under development and will be ready for implementation at the beginning of 1983.

This effort will supplement a similar effort in the private sector recently announced by a coalition of health care providers, health insurers, business and labor. The 372 million in savings expected from this initiative reflect the combined public and private sector efforts, as well as our legislative proposal to eliminate provider, waiver liability. The enormous regional variations in lengths of stay and cost of care for similar diagnoses lead one to conclude that this savings target could be achieved in a number of ways. Some examples of actions that would produce these savings, either alone or in combination include:

A reduction of one-third of a day in the average length of a hospital stay.

3.3 percent reduction in the use of unnecessary hospital services.

A 2 percent reduction in the use of hospital ancillary services, such as laboratory tests or x-rays.

In our judgment, the use of Medicare contractors in conjunction wiht similar efforts in the private sector is a more efficient and less burdensome way of accomplishing an important objective: to ensure that services provided to Medicare beneficiaries are necessary. As the Congressional Budget Office pointed out, the PSRO program, in total, was an expensive program in relations to the benefits it achieved. It was also a burdensome form of Federal regulation.

In addition, the use of Medicare contractors has advantages over the current PSRO program;

It will be more efficient because providers will no longer have to be responsive to two different organizations: one for bill processing and one for utilization review.

Medicare contractors will be able to review the whole range of Medicare services, Part A as well as Part B. PSRO review concentrated almost totally on hospital admissions.

Finally, the private sector effort, in conjunction with the Medicare contractors, will be able to focus attention on utilization in the entire health care system. One of the criticisms of the PSRO program was that it simply shifted costs to the private sector.

6. SOCIAL SECURITY

Question. The budget appendix indicates proposed legislation in the form of a "Limitation of Administrative Expenses." This proposed legislation would affect matters within the jurisdiction of the Committee on Ways and Means, some of which arise out of the Social Security Disability Amendments of 1980. These include payments for medical evidence, detailed denial notices, preeffectuation review, and attorneys' fees. Do you expect to have this legislation developed within the Committee on Ways and Means, or do you prefer to have this legislation go through the Appropriations Committee?

Answer. We prefer to have these proposals developed within the Committee on Ways and Means. However, parallel appropriations language changes are included in our budget submission to ensure that we achieve the administrative savings assumed in our fiscal year 1983 budget.

We are planning to include the proposals relating to payment for medical evidence and personalized disability denial notices in our proposed legislation of 1982 which will be submitted to the authorizing committees. The proposal to hold the level of preeffectuation review of allowances of disability at 35 percent was proposed by the Administration in our report to the Congress last fall on the cost-effectiveness of the preeffectuation review process. We are ready to provide whatever technical assistance you may require.

Chairman ROSTENKOWSKI. Mr. Anthony will inquire.

Mr. ANTHONY. Welcome before the committee, Mr. Secretary.

I have attended several of the field hearings that the Ways and Means Committee held across the country. One that I attended was held in Memphis. Representatives of various volunteer associations from Mississippi, Tennessee and Arkansas appeared there, and in fact one young lady came who is a volunteer from Prescott, Ark., representing a SCAN project, which is a suspected child-abuse and neglect project, which has been funded under title XX. She is a volunteer and she came on her own just to talk about the problems they were having with that particular project.

During the course of listening to her testimony, in reviewing the record I noticed that I made a promise that when I came back to Washington, I would ask those specific questions for her. So now that I have the opportunity, I think I will direct those questions to you so that we can have a record made so that I can send her the answers.

Basically what she said is that responding to a Harris poll showing that 91 percent of the majority of the people polled in the United States considered child abuse to be a serious problem, and 75 percent of the majority was convinced that the major responsi-

bility should be taken over by the Government to deal with abuse of children.

The SCAN program actually originated in the State of Arkansas. It has been going on for 2 years. Her plight was simply this. Because there was a cut of approximately 15 percent in title XX funds last year, her requirement of local matching money went up from $6,000 to $35,000. As a result of making State priorities because of a tight State budget, they had to make a decision to close some offices. Unfortunately, one of the offices that was chosen to be closed was the one she was operating in a three-county area.

She went on to state how many cases they had handled, the success ratio that they had had, and it seemed very impressive. She was just very concerned that just when a program was proving successful and spreading into other States, the State was forced to make priorities because the Federal Government was forced to make priorities in cutting out monies from these programs. She was upset with the decision to make cuts in a program with so little fat.

I guess my question to you, Mr. Secretary, is what can we hold out as an offer of hope to volunteers like Mrs. Gail Young from Prescott, Ark., who has been working for 2 years already as a volunteer, yet being forced to face the consequences of the sharp cuts that are coming out of Washington? And I guess as a final question, would you as Secretary of that department be willing to take a close look at that particular project to see if it would be one that you could endorse the concept of and maybe expand the concept so that we can provide some needed services to these child-abuse and neglect cases?

Secretary SCHWEIKER. Let me point out that there are two levels we are really talking about, Congressman. You mentioned the title XX level, and of course this is not a new thing with this administration. Title XX has always been a block grant approach in recent years, so they would have the decision at the State level to make that cut, and of course it was their call.

We do have a small program, a categorical program for child abuse. I arm wrestled with OMB on this program and we got it funded at the same level this year. So one suggestion I could make is if they would apply to us through the categorical child-abuse program, I cannot promise we will do something but we will certainly take a look at it because there are a limited number of projects that because I did fight successfully cuts in our categorical child abuse program, we will take a look at it on that basis.

I don't want to commit because we obviously have some competing priorities in that program, but we did keep it, it is still there, and it didn't get cut by OMB.

Mr. ANTHONY. Well, I guess going back to the factual basis of what Mr. Downey said earlier, Public Law 96-272 is going to take a $120 million cut, and the block grant title XX social services program would be reduced by an additional $425 million. These are two areas that she would hope to be able to look to. She understands the difficulties with trying to do more with little money, but sometimes as we try to look at the overall picture, sometimes we do not see some of these worthwhile projects that are just beginning to get started.

It appeared to me that it was something that was right in line with President Reagan's concept of voluntarism, and here is a group of people who really were volunteering services, most of the furniture was donated, the office space was donated, they were actually going around and raising $50 contributions from the community. The problem they have run into now is that they are under the United Fund, they cannot solicit additional funds because the United Fund has a restriction that you cannot solicit additional funds if you draw United Fund contributions. So they have just run into a lot of obstacles.

I just lay it out for the record. I ask you to take a look at it.

Secretary SCHWEIKER. How much funding were they getting a year?

Mr. ANTHONY. It was a small program to begin with, I think $90,000 is all, but they had actually been able to touch 1,100 families.

Secretary SCHWEIKER. I think if you would have them apply through our categorical child abuse program, we will sure take a good look at it. That is another mechanism.

Mr. ANTHONY. I will ask them to do that, and I would just ask for you to suggest to whoever the proper lieutenant is you have behind you there to work with me on that and maybe contact me. I would love to have an office appointment set up. I thank you very much.

Mr. FORD [presiding]. Mr. Gephardt.

Mr. GEPHARDT. Thank you.

Mr. Secretary, my questions fall into two areas and really go into the question of whether or not the cuts you are asking for are cost efficient and they will really do us any good in the long term. First in the area of health, which we have discussed many times, and as you know, I agree with many of the things you are trying to do for the future, and in the area of railroad retirement. The specific change there is not understandable to me because I don't quite know where you are trying to go.

Let me start with railroad retirement. The Social Security Administration apparently faces both administrative and financial crises. A GAO report which was published in December of 1981 said Social Security's daily operations are being threatened by serious problems in its computer operations. The agency itself says it is facing a crisis in managing its computer systems.

In addition, I am sure we all know that we are having financial crises that have to be addressed in social security. What I am curious about is the effects of the administration's proposal to eliminate the Railroad Retirement Board as a Federal agency of the Government and to switch a portion of the current railroad retirees' benefits from the Board to the Social Security Administration.

First of all, given the personnel and computer problems facing SSA and the fact that no new moneys or positions have been earmarked for SSA, how can we be assured at all that SSA can handle the new workload of over 1 million railroad retirement beneficiaries?

Second, this proposal would increase costs of the social security trust fund by $1.7 billion in this fiscal year. My question is won't this action only further jeopardize the solvency of the social secu-

rity trust funds? I cannot understand why, if we are not going on to do some substantive changes between social security and railroad retirement, why at this point when we face a crisis in running social security, that we would want to make this change. It seems to me it is being made for almost ideological reasons rather than any practical reasons.

Secretary SCHWEIKER. Well, Congressman, I certainly appreciate your leadership and interest in the health area and these other areas that we have discussed here. I think you have played a very positive and constructive role.

In regard to your two specific questions, on railroad retirement I will be very candid and say that this recommendation did not come from us; it was not our recommendation. It does not now come under our jurisdiction. Somebody else is recommending that it should come under our jurisdiction, and the proposal for doing this is at OMB, so I do not know what the details of that proposal are.

Mr. ANTHONY. Would my colleage from Missouri yield?

Mr. GEPHARDT. Yes.

Mr. ANTHONY. I just want to commend you for bringing this particular issue up. It is also an issue that I have a great deal of concern about. It is an area that is of grave concern to many of my constituents in south Arkansas, principally Pine Bluff, Ark., and I just want to commend you for bringing it up. I would also like to explore with the Secretary and with you any further modifications that we could make to make sure that those people are not unduly affected.

Mr. GEPHARDT. Well, Mr. Secretary, your department has the responsibility for administering social security, and I really think we have to think this one through because if we are going to complicate the administration of social security, which is already in dire trouble because of our capacity to handle what you have, I am just not sure this recommendation makes any cost sense at all to the Government.

Secretary SCHWEIKER. Well, we have not seen the details of it yet, Congressman, so it is a little hard to comment on it. By the same token, I would assure you that when we do get the details of whatever recommendation there is on it, we will look at that from the very standpoint that you are talking about because it will be our responsibility to try to bring some order out of chaos.

Mr. GEPHARDT. Let me follow up, then, on the health area. I really get the same feeling that we are being faced with a similar situation there where I think recommendations are being made to the Congress that really come out of a budgetary outlook rather than the outlook of what good health policy should be.

I think that you are moving in the right direction, from my viewpoint, on health care. I think the ideas that you are presenting to the administration are the right ideas. I think you have the long-term view. But the cuts I see here from, I suppose, OMB, do not reflect to me any long-term view of where we are going.

Let me be specific. We have a laundry list of medicare and medicaid cuts. Some of them bring in, you know, $35 million in revenue, $10 million, $54 million, $18 million. They are all tough. They are all hard to do. They all affect a certain part of the health provider constituency. I do not see that if we made all these cuts, that

we would be effecting any change in the structure of health care in America. In fact, I think we complicate that effort by making these cuts in this way.

Let me be more specific. As you know, I was the leader of fighting mandatory cost containment, but I have looked at the numbers and there are lots of proposals now about freezing medicare and medicaid to the CPI, which I am told would save $7 billion in 1983. I am wondering if in conjunction with your proposals for long-term change in the health care industry it would not make more sense, rather than going through this laundry list, to simply propose a deeper cut in reimbursement in medicare and medicaid at the same time we offer a voucher or something that will move us to a new system which will save you maybe not as much as $7 billion but would save you at least as much as this list would, and I think would signal to the health care industry and to the providers, the hospitals and the doctors, the kind of change that we are really advocating in the health care system.

You know, I think a lot of the health care industry is going to come in and say we can live with 2 percent or we might live with that one or this one, and we will have a negotiation here and we will come out with about half this list, and they will more or less live with it. The part they don't, they will force over onto the private payors, and we will still have the system the way it is.

Finally, I was distressed to see in your testimony that apparently we are not going to get a proposal from the administration on affecting the taxation of private health insurance. In my view, as you well know, if we are going to get real change in the future in health care, we not only have to give different incentives in the public sector but we have to give different incentives in the private sector.

I would appreciate your response.

Secretary SCHWEIKER. Congressman, first if I may answer the earlier question on the computer problem in social security, which is a very real problem, I certainly concur with the thrust of your question. I am very pleased to announce that next week we will have a full-scale proposal for a new modernization and update plan for social security computer systems.

It will be presented to the responsible people. I think it will be a very comprehensive, long-range, modernization plan. So we are making some progress there. We will have very specific recommendations next week on that.

Going back to the thrust of your question, I would agree, Congressman, that the point you make is true, that the proposals that we have in this package really don't address themselves to the fundamental structure and I would also agree that that is really the most fundamental thing of all.

On the other hand, there is one other area that I didn't mention in my statement that we are really looking into quite intensively, and it isn't covered under what we are looking at in terms of competition, per se, and that is prospective reimbursement.

I have come to believe that one of the quickest and most effective things we can do is to move into the area of prospective reimbursement. So one of the things that should be viewed in this package which is clearly a structural reform will be prospective reimburse-

ment. I have HCFA working on it right now. We expect some things coming up to me in the next month or two, and that is something we hope to move into high gear that will go into structure.

On the other aspect of it, we haven't ruled out the tax limit. It is still under consideration. It is one of the options. We will make a final cut within a week or so, but that is still on the list, although there is some opposition to it, quite frankly.

Mr. GEPHARDT. If I could just get a little more time, do you have an opinion or could you develop for me an opinion as to what the effect would be of instead of doing the list of cuts that you have presented us, if you would just increase the reduction in reimbursement under medicare and medicaid to 5 percent or 7 percent or even 10 percent? Could you give me a figure for how much that would save as compared to the list of cuts you have?

Secretary SCHWEIKER. Sure. In other words, to lump all the savings together and substitute it with a percentage?

Mr. GEPHARDT. Just put a flat percentage to achieve the budget level that you are talking about, because I think we are dealing at the margins with these proposals. I do not think we are sending anybody a message. I think the hospitals, the medical community, are just going to sit back and do business as usual.

If we get a voucher program in, maybe that will start affecting things. I think we have to send them a message and I do not think these budgetary proposals do. I realize that I am the one who pushed the voluntary effort. The voluntary effort hasn't worked. It is all over with. It is finished. And we have to get hold of this problem.

We have to get change and I am beginning to think the only way to get it is to get a clear message out there, and if we have a budget problem we have to deal with, I would rather deal with it that way as long as we can couple it with a voucher proposal being put in place.

Secretary SCHWEIKER. We will get that information for you, Congressman. Also, I would say I think prospective reimbursement has a real hope here to reform the structure and to do some of the things you want to do as part of this package. So we will be getting to the Congressman on that as well.

Mr. FORD. Thank you. Mr. Secretary, I chair the Ways and Means Subcommittee on Public Assistance and I have studied the proposed 1983 budget cuts affecting several programs that we would have jurisdiction over in the Public Assistance Subcommittee—the title XX social services as well as the AFDC and the low energy assistance program.

Mr. Secretary, last year the President proposed and the Congress passed large reductions in the title XX, as well as AFDC, programs. This year you are proposing additional large cuts in Federal funds for these programs. What is the total combined reduction in Federal funds for these two programs in fiscal year 1983 resulting from the cuts enacted last year as well as the proposed cuts for the 1983 budget?

Secretary SCHWEIKER. Which two combined programs?

Mr. FORD. When you combine the fiscal year 1982—the present fiscal year, where we passed the reconciliation last year in the Con-

gress—combined with the proposed cuts that are in the 1983 budget recommendation.

Secretary SCHWEIKER. This is on the social services program?

Mr. FORD. This is on title XX in the social services and AFDC.

Secretary SCHWEIKER. For the years 1981 to 1982 it was a $591 million cut, and then for this budget it is $427 million. So you would add $426 million and $591 million, if I understand your question, and that sounds like about $1 billion.

Mr. FORD. Now that is just title XX. Is that correct?

Secretary SCHWEIKER. That's correct.

Mr. FORD. What about AFDC benefits?

Secretary SCHWEIKER. We estimated last year in that program about $1 billion—another $1 billion, Congressman—for the last year's savings.

Mr. FORD. How much did you do last year?

Secretary SCHWEIKER. $1 billion last year.

Mr. FORD. What about 1983?

Secretary SCHWEIKER. About $1 billion this year.

Mr. FORD. About $1 billion, coming to a total of about $2 billion?

Secretary SCHWEIKER. $3 billion, if you put all three together.

Mr. FORD. If you put all three together because of the effect it will have in 1983.

Secretary SCHWEIKER. Both the cuts in 1982 and 1983 for those two programs would run about $3 billion. That's right.

Mr. FORD. The administration estimated that upwards of some 700,000 families would lose their AFDC eligibility or have their benefits reduced as a result of the AFDC cuts enacted in last year's reconciliation.

Now how many additional families will lose AFDC benefits under this year's proposal and what is the total number of families that will be affected in fiscal year 1983 due to the changes enacted in last year's proposed AFDC changes?

Secretary SCHWEIKER. I am not sure we have an accurate figure, but we will sure get it to you very quickly.

Mr. FORD. Mr. Secretary, how did you arrive at all of these saving estimates if you are not sure on a figure that you can tell us? What are you doing? What are you saying to the Congress in this proposed recommendation?

Secretary SCHWEIKER. We are taking estimates. A budget is an estimate, so the question is how accurate is your estimate. And we have to validate that because whatever figure we end up using will be in page one headlines across the country. I think in fairness to everybody we should try to get as accurate and responsive a figure as we can.

Mr. FORD. Do we have any figures we could go on? What are your numbers? I am sure you have some numbers before you, Mr. Secretary.

Secretary SCHWEIKER. Well, the figures I gave you were rounded figures and I tried to be responsive to those.

Mr. FORD. I have not received any figures on the families that would be affected. You gave me some dollars on the social services, on the title XX.

Secretary SCHWEIKER. The billion-dollar figures were rounded figures and that's why I would like to get our estimates.

Mr. FORD. In other words, in AFDC how many children are going to be affected? How many children were affected in the past reconciliation budget cuts? How many children will be affected in the proposed budget cuts and, if so, how many children under the age of 6 years old will be affected? How many children under the age of 3 years old will be affected if these proposed cuts are adopted by the Congress?

Secretary SCHWEIKER. Well, this is one of the items on the list of questions that the chairman asked and we hope to have that by Friday. I promised it to him by Friday. But, you know, we give you a figure and it is a rounded figure, not a precise figure, and then that is the figure that becomes the figure. And as you know, these are sensitive areas, no question about it.

But I think we have a responsibility to be accurate in what we say. We will give you the information. You will have it, I promised the chairman, by Friday.

Mr. FORD. A few other questions, Mr. Secretary. How many individuals were denied title XX social services because of last year's cut of some $685 million and how many additional individuals will be denied services if we cut the additional $748 million that is being proposed by the administration at this time, giving us a total cut of some $1.2 billion that the President has proposed for this year?

Secretary SCHWEIKER. Mr. Chairman, here is a case where, because they are block grants and they are run by the States, we wouldn't have those figures. I mean, it's a State-run program. They keep the figures. They do the administering of it and it's been this way for some time. It's nothing new. So those I don't believe we would have.

Mr. FORD. In other words, we could not get figures as to how many elderly and disabled individuals are affected by last year's budget cuts as well as the proposed budget cut that is before Congress now?

Secretary SCHWEIKER. Where we have a categorical program, yes, we do, but where we have a block grant program, the whole theory of the block grants is the States run their own programs, set their own criteria, disburse their money and use their own agencies. So they would have those figures. We don't have them, and that's the whole theory that we are trying to get out of the paperwork and the administrative burden and the cost because they are running the programs.

Now let me say this. I am sure at some point in time the States will be reporting back on what's been happening and we probably may get some data, but we just don't have a handle on that.

Mr. FORD. Mr. Secretary, if you received information to the effect that the title XX cuts were forcing elderly and disabled individuals to move out of their homes and into nursing homes because of the title XX cuts in day care and the repeal of the earnings disregards, working poor mothers were quitting their jobs, would the administration support a restoration of funds and repeal or modification of some of the AFDC amendments enacted last year in the reconciliation?

Secretary SCHWEIKER. I have said, even last year, that we would keep an open mind on what the impact was and how severe it was. And we certainly are going to keep an open mind.

By the same token, I don't think—we are not yet halfway through the fiscal year, so I don't think we have any idea what the impact is. But we certainly will, when we get an impact analysis statement. We will be back to this committee and we will keep an open mind on just what that impact does or doesn't mean. But I don't know at this point.

Mr. FORD. You do understand that this full committee, we have had field trips throughout this country and we have heard from those who have been affected by the budget cuts in the last session of the Congress.

Secretary SCHWEIKER. I understand they are very effective.

Mr. FORD. Mr. Secretary, the maximum AFDC benefit for a family of three in Missouri is $248 per month. It is $255 in Indiana and $263 in Ohio. Now there are States with lower benefits levels, and I am from one of those States, Tennessee, where I think it is $122 per month.

But I have picked these three States because they have fairly low benefits, but also because they have quite harsh winters. My question at this point is, one of the administration's AFDC proposals for this year would require States to count any low-income energy assistance received by AFDC families as income for AFDC purposes.

I would like to know to what extent would this reduce the benefit for a family of three living in Missouri, Indiana, or Ohio. Would these or other States be required to reduce their AFDC benefits because they are recipients or receive low-income energy assistance from the Government?

Secretary SCHWEIKER. The reason for our initial proposal was the AFDC needs standards does have a utility allowance. So it already has this factored into it. So what we have been doing, because we have been increasing that allowance, is that we really are putting it through the system twice.

They are getting double credit for that allowance and I think when you target needs and target where your dollars can cover the most people in need that eliminating that duplication is a fair and equitable response with only so many dollars to go around. And that is what we are proposing.

Mr. FORD. Are you saying that a family of three that is living in Ohio that would be recipients of $263 a month, with the possibility of an additional $160 per month in food stamps, is not poor enough to receive energy assistance and that, if so, that those dollars should be counted along with the AFDC dollars?

Secretary SCHWEIKER. Well, of course, in addition to what you have given me you have to add in food stamps.

Mr. FORD. Just take the $263 a month in Ohio, with the possibility of $160 in food stamps.

Secretary SCHWEIKER. How about medicaid and housing subsidies and the earned income tax credit?

Mr. FORD. Well, how much are we talking about?

Secretary SCHWEIKER. My point is that all these things are over and above that figure, so that's one of our problems. I think we have been giving assistance through six or seven different channels

and you just can't take an isolated figure if they are getting $800, $1,000 or $1,500 of medicaid expenses paid or if they are getting a rent subsidy, an unearned income tax credit, it isn't fair to just focus on that.

Mr. SHANNON. Would the gentleman yield?

Mr. FORD. I will be happy to yield.

Mr. SHANNON. Does your proposal deal with just AFDC or with the combined figure of all of these things together?

Secretary SCHWEIKER. Our proposal is just AFDC.

Mr. SHANNON. Then why didn't your answer just deal with AFDC?

Secretary SCHWEIKER. Because I am trying to tell you, Congressman, that people get other income besides the figures he is focusing on.

Mr. SHANNON. The proposal just deals with reducing AFDC benefits.

Secretary SCHWEIKER. Are we saying the poor are in need of money? Then I am saying where they get other resources from.

Mr. SHANNON. Take the hypothetical situation that Mr. Ford gave you of a family of three in Ohio that receives just $263 in AFDC benefits and $160 in food stamps. They are not poor enough for fuel assistance under this administration's proposal?

Secretary SCHWEIKER. Again, a lot of these things——

Mr. SHANNON. Can you answer the question?

Secretary SCHWEIKER. What's the question? You have a way of making a statement instead of asking a question.

Mr. SHANNON. A hypothetical family in Ohio receiving just $263 in AFDC benefits and $160 in food stamps, which was the hypothetical posed to you by Mr. Ford, is not poor enough for fuel assistance under this administration's proposal. Is that correct?

Secretary SCHWEIKER. What is the question?

Mr. SHANNON. The question is, is a hypothetical family in Ohio, a family of three receiving $263 in AFDC benefits and $160 in food stamps poor enough to receive fuel assistance?

Secretary SCHWEIKER. I would really have to look it up. I don't know.

Mr. SHANNON. If they did receive fuel assistance would they get their AFDC benefit reduced under the administration's proposal?

Secretary SCHWEIKER. I really don't know. You come up with a hypothetical case and say do they qualify or don't they qualify.

Mr. SHANNON. Is your proposal to reduce AFDC benefits dollar for dollar for fuel assistance?

Secretary SCHWEIKER. Where there is a duplication, yes—only where it is duplicating. In other words, if they have an allowance already in there for utilities and we are paying them another utility allowance.

Mr. SHANNON. Let's see if I can make it simpler for you, Mr. Secretary. A family of three in Ohio receiving a $263 AFDC benefit and $160 in food stamps gets $30 in fuel assistance. Will you reduce their AFDC benefit by $30 under your proposal.

Secretary SCHWEIKER. We would if——

Mr. SHANNON. They would not be poor enough to get fuel assistance unless you reduce their AFDC benefit.

Secretary SCHWEIKER. If they have been getting an allowance already for utilities, the $30 would be reduced. That's the purpose of it.

Mr. SHANNON. Thank you.

Secretary SCHWEIKER. I didn't know it was that complicated, Congressman. I thought it was clear cut.

Mr. FORD. Mr. Secretary, what are they going to do? What are they going to burn to stay warm if you are going to take dollar for dollar from the AFDC benefits? What are they going to do to stay warm? What can they burn in that house?

Secretary SCHWEIKER. Well, they were already calculated to get that dollar, so already the calculation was built in for that assistance. They already have been credited for getting that dollar. So what we have been doing is we have been duplicating a benefit that they actually are getting twice, so they are going to use the original benefit and not the duplicate benefit. That's the purpose of this proposal.

Mr. FORD. The standard of need, whatever it is, in Ohio—well, let's take Tennessee. Of $122 a month, are you then saying that a family of three in the State of Tennessee would have already had, as a part of their standard of need for being a recipient of the $122 a month in AFDC benefits, that that dollar amount would in fact represent any and all energy assistance that they would receive from the Federal Government, to be counted against their AFDC payments monthly? Is that correct?

Secretary SCHWEIKER. Congressman, you are going on the assumption that the State, whatever State you are talking about, can't adjust its needs standard and——

Mr. FORD. Let's talk about any State you want to talk about. We can talk about your State that you represented so well for so long in the House and in the Senate.

Secretary SCHWEIKER. They can adjust the need standard. That's the point. The whole system is built so the State can adjust that needs test and if it is not adequate, it can be adjusted. You just presume the States will do nothing, they are incompetent, they can't deliver any services and if that's your presumption, fine. But that's not our presumption.

And you can't hang us with your presumption.

Mr. ANTHONY. Would the chairman yield?

Mr. FORD. I would be happy to yield to the gentleman from Arkansas.

Mr. ANTHONY. I was going to ask a question later on, but this seems to be a good time to interject it.

As I understand it, the administration is proposing that States be required to prorate shelter and utility costs for AFDC families and large households. Is my understanding correct?

Secretary SCHWEIKER. I think that's correct; yes.

Mr. ANTHONY. So if I understand it correctly, the administration is proposing now to require the States to prorate—prorate shelter and utility costs for AFDC families?

Secretary SCHWEIKER. If their families are realizing an economy of shelter from that, yes; not if they are not.

Mr. ANTHONY. My second question would be do you have any figures or do any of your employees have an indication as to how

many States now currently reflect a shelter cost within their standard of needs?

Secretary SCHWEIKER. I don't have any here but we can provide it for the record. I am sure we have it.

Mr. ANTHONY. The reason I would like you to check into that is it is my understanding from having looked at it previously that most States right now do not prorate the shelter costs in the needs standards. If that is a correct assumption—and your research will bear it out—but if that is a correct assumption that would then lead to my actual question.

Would that not be unfair for the administration, through a change in the law, to impose that on the States and in fact does that not take away some of the flexibility that you were talking about as you got into the exchange with the Chairman on that point?

Secretary SCHWEIKER. I think we are confusing two things here. This is only where there is a combination of families and both families are getting an allowance for the same thing. That's all we are talking about—where both families are getting the same allowance, even though their costs may be only 50 percent of what that is. So other than that we are not combining utilities.

Mr. ANTHONY. I am assuming, then, a situation and I guess that is the reason I asked the question to begin with, because I come from the south and I know that many AFDC families have grandparents living with them. I know that most of the recipients of these benefits, like in Arkansas 73 percent of them, are children. Most of them are either single or divorced women with runaway fathers who are not paying child support and the grandparents live with them, and in many cases it is only the grandmother.

And if I understand you correctly, what you are saying is that you would now require the States to prorate that through that family. Again, I assume, based on having read some figures before I came here, that about a third of the recipients of AFDC in the south, and even in my district in south Arkansas, would be covered under this. In other words, you have about 33⅓ percent that would be treated somewhat differently.

I guess I am just trying to determine if that is fair or not. I am not coming in here with any preconceived ideas. I am really exploring, trying to get the basis for the decision and the justification so I can make up my mind whether it is a good or a bad proposal.

Secretary SCHWEIKER. I think the best thing is, let us give the figures, because the figures will speak louder than whether I am giving you a straight answer or not, because without the figures I cannot be sure.

Mr. ANTHONY. I thought it was a proper time to interject it because it's a concern that I have for some of my constituents. And again, I have no preconceived idea whether it is fair or unfair. I really want it to be determined on a factual basis. I thank you.

Thank you for yielding, Mr. Chairman.

Mr. FORD. Mr. Downey?

Mr. DOWNEY. Thank you, Mr. Chairman.

Mr. Secretary, if you would resist the temptation to give us anecdotes, let me return to the question that I asked you before you

started telling me about a $29,000 welfare family in New York, which is not particularly useful in terms of helping us to legislate.

The Child Welfare and Foster Care Reform Act of 1980 was designed to prevent children from remaining in foster homes, to keep families together. It was also designed to make sure that there were counseling services for neglected and abused children in families. The President is proposing to cut title XX by $425 million and cut the funding for the child welfare and foster care program from over $500 million down to $380 million. He is proposing that the program be a block grant and eliminate any federal examination of State activities to determine if the goals of the program are accomplished.

My question for you, Mr. Secretary, is, What role do you see for your Department in accomplishing the goals of the child welfare and foster care reform program, when you are cutting the money and you are not going to do the State enforcement, which was exactly one of the reasons why the law was enacted in the first place?

Secretary SCHWEIKER. Well, Congressman, I do not disagree with the reason the law was enacted. I concede that point. I think there certainly has been a need in the area and I think we all felt the need. And we have made a proposal to do it in terms of a block grant.

But I would like to remind you that the Appropriations Committee of this body put a cap on it. So the Appropriations Committee itself in this body made a decision that there should be a limitation on what the spending was, because they thought it was one that was also prone to take off and to get into excessive overruns.

We have an open mind in this area. If you have some proposals that protect some of the standards and some of the things that you feel have been not covered well in the past, we will take a look at that. I recognize that there has been some things that——

Mr. DOWNEY. Mr. Secretary, let me see if I can't clear up some error here. Under the continuing resolution, the Congress took the cap off foster care. Are you referring to the cap on title XX? To which cap do you refer?

[Pause.]

Secretary SCHWEIKER. Our understanding, Congressman, under the continuing resolution is that the effect of the CR was to cap the foster care area at $300 million.

Mr. DOWNEY. I am informed by staff that there is specific language in there not to do that. So we will have to at some point resolve those differences.

Secretary SCHWEIKER. If you will give us that, we will certainly take it to our general counsel.

Mr. DOWNEY. Mr. Secretary, I want to read for you, and I do not want to engage in any browbeating, because I think there is a very, very fundamental difference of view between what this administration is doing for the poor, to the poor, to children, and that which I would like to see have done to them. I want to read you the last paragraph of the Bishop Sullivan statement, who is concerned about this entire issue, and put it in some perspective.

Without trying to characterize you personally one way or the other, the fact that your Department spends more than $56 billion more than the Defense Department is totally and completely irrele-

vant. The fact that you spend more money than the People's Republic of China does not make you any more communistic than the People's Republic of China. It has absolutely nothing to do with anything that is of relevance to the poor or to the needy.

The bishop says:

I wish to emphasize that the debate over entitlement programs, as well as the larger debate over the federal budget, is not simply a debate about numbers and programs and dollars. It is about human beings—children, parents, the elderly, their joys and their sorrows, their successes and their failures, their hopes and their dreams. It is about American families, about whether or not they will have enough food on the table, enough income to support them, enough medical care to guarantee their full physical and mental development. It is, in short, a debate about human dignity.

With all due respect, this is not a budget that provides for human dignity. This is not a budget that provides for human hope. This is a budget that will provide additional increased misery for the poor, for the young, and for the elderly.

Secretary SCHWEIKER. There is no question that we differ philosophically here, because the point I was trying to make and obviously passed you in the night was that when the country was racking up $90 billion deficits and my Department is increasing 17.6 percent at a clip, we are a pretty big contributor to those deficits. And there is no question in my mind that it is deficits and the high interest rates that are denying the low-income people jobs, that are denying growth to occur, that are keeping people from moving up the ladder.

So in terms of hurting people or in terms of hitting the people who are down and out, the high interest rates, high unemployment, are the most devastating effects. So I totally disagree philosophically about what the impact is.

Mr. DOWNEY. Mr. Secretary, the only thing that has passed me in the night is the substantial reasoning that underpins this budget, because in my opinion this is a budget that is more and more out of mean-spiritedness than any logic I can see.

I have no further questions.

Mr. FORD. Mr. Bailey?

Mr. BAILEY. No additional questions.

Mr. FORD. Mr. Secretary, I would like to thank you for coming before the committee. One of our colleagues, Mr. Pickle of Texas, has submitted some questions in writing, and I would like to make them a part of the record and also ask that you respond to the questions, to Mr. Pickle. He is not here, but he wanted the committee to submit the questions to you and be made a part of the record.

[Questions for the record submitted by Mr. Pickle follow:]

ADMINISTRATIVE EXPENSES

Question. Secretary Schweiker, in the budget in the section on limitation of administrative expenses for HHS you include several legislative proposals which affect areas which have been of concern to the Subcommittee on Social Security for some time and which in some cases were included in legislation authored by the Subcommittee in the last Congress. Do you intend to submit these legislative changes to the Ways and Means Committee for action or simply include them in your appropriations request? The areas include:

Fiscal year 1983 savings

	Millions
Limitation on 75-mile travel	$2.0
Reduce review of attorney fees	7.0
Eliminate personalized denial notices	31.0
Reduce payment for medical evidence of record	11.4
Reduce future requirement for preeffectuation review	9.5
Total	60.9

Response. The Administration is willing to work with this Committee to identify the best vehicle or vehicles for advancing these proposals. We would be glad to provide whatever technical assistance the Committee on Ways and Means would find helpful in its consideration of these proposals. (The item limitation on 75-mile travel was included in the Continuing Resolution for FY 1982.)

OVERPAYMENT COLLECTIONS

Question. Secretary Schweiker, one proposal that the Administration has sent up in the SSI program is to authorize collection of SSI overpayments from other SSA-administered programs such as social security benefits themselves. Isn't this using the social security system as a federal collection agency? Why should we use the social security benefit for this purpose?

Question. On page 10 of your testimony you mention "some changes that also affect administration of the OASDI system of social security."

What are the changes to which you are referring?

Response. We are proposing the following changes that are intended primarily to facilitate program management and administration or to maintain or improve program integrity without basically changing benefit provisions. The proposals are:

Collection of overpayments in the SSI, Social Security or Black Lung programs that were uncollectible under the program in question by withholding payments under another of the programs;

Ending the practice of paying for medical evidence of record under the Social Security DI program;

Discontinuing the furnishing of highly detailed explanations of denials of OASDI and SSI disability benefits;

Ceasing the fixing of individual attorney fees for successful representation before SSA and the withholding of fees from back benefits due to claimants,

Retention of the current 35 percent level of preeffectuation review of allowances of DI benefits, rather than increasing the level to 65 percent in FY 1983, until experience indicates what level of review would be most cost effective.

IMPLICATIONS OF NEW FEDERALISM FOR SSA

Question. Mr. Schweiker, I understand that under the original plans for the "new federalism" there was to be a massive shift of responsibilities for some programs now administered by the Social Security Administration, mainly AFDC, to the States, and an assumption of responsibilities for Medicaid by the Federal government, specifically by Social Security. I now read that the President has agreed with the governors to leave the details on AFDC open, but to go ahead with Federal assumption of Medicaid. Is this true—are you planning to have SSA assume Medicaid administration?

I have two questions on this:

First, what administrative implications does an assumption of the Medicaid program have for Social Security? Doesn't SSA perform many tasks for the Medicare program that they are not reimbursed for already? Won't adding Medicaid to the field workload, not to mention SSA's overloaded computers, make service to SSA's beneficiaries to deteriorate? Is the Administration prepared to give SSA the resources to handle this workload?

Second, if the President is now holding open the possibility of not turning AFDC back over to the States, will SSA be expected to continue administering AFDC and still take over Medicaid as well? Isn't this overburdening SSA with even more programs that it was not originally designed to handle?

[Responses to some of the above questions were never received.]

Mr. FORD. We have made it clear that we do have a genuine concern about the elderly, the handicapped, and the children of this country. And I am sure that you share that same feeling, Mr. Secretary. And I would hope that we would be in fact a lot more sensi-

tive to many of these programs and the issues we have discussed and talked about today, because they do in fact impact upon the children of this country, who cannot speak nor represent themselves in the Congress.

And we would hope, looking at your record here in the Congress and the 20 years of public service as an elected official and your voting record in the Senate, it is clear that you have shown compassion in the past as an elected official, and we would like for you to continue to be a spokesperson for the handicapped and the disabled and elderly and the childen of this country.

And Mr. Secretary, with that, we really appreciate the fact that you have given us your time today and testified before the committee.

Secretary SCHWEIKER. Mr. Chairman, I thank you for your comments. And I do want to say that one of the battles I did fight successfully in this budget process was the elimination of Head Start. Originally there was a proposal from OMB to push Head Start back to the States and to reduce it 25 percent a year. I fought that. I thought this was a program that clearly was in the safety net. It affected our urban youths. It was a $1 billion program. And I successfully appealed that. I was prepared to go all the way up the ladder.

So I appreciate what you said, and I think I can show in some of the key instances that we have been successful in avoiding some retrenchment in some of these areas. But I appreciate the chairman's remarks.

Mr. FORD. Mr. Secretary, thank you very much, and your staff.

The committee will reconvene at 2 p.m., and we stand in recess at this time. Thank you.

[Whereupon, at 12:55 p.m., the committee was recessed, to reconvene at 2 p.m.]

AFTERNOON SESSION

Chairman ROSTENKOWSKI. The committee will come to order.

I know that you are on a tight time frame, Mr. Secretary. I appreciate your courtesies in joining us and outlining the program that has been suggested by this administration. It is for that reason that I will not delay opening the committee and taking your testimony. We look forward to hearing from you and we appreciate your participation. On behalf of all the members of the committee, I am pleased that you have joined us. If you are ready, Mr. Secretary, you may proceed.

STATEMENT OF HON. RAYMOND J. DONOVAN, SECRETARY OF LABOR, ACCOMPANIED BY BERT LEWIS, ADMINISTRATOR, UNEMPLOYMENT INSURANCE SERVICE, AND JAMES VAN ERDEN, SUPERVISORY ACTUARY, DEPARTMENT OF LABOR

Secretary DONOVAN. Thank you very much, Mr. Chairman.

I have brought with me, on my right, Bert Lewis, who is the Administrator of UIS; and on my left, Jim Van Erden, who is Supervisory Actuary at the Department. I have a short statement that I would like to read.

Mr. Chairman and members of the Ways and Means Committee, it was just about a year ago that I appeared before you for the first time, to present the unemployment compensation component of the President's economic recovery program. I am pleased that virtually all of our recommendations were approved by the Congress and enacted into law as part of the Omnibus Budget Reconciliation Act of 1981.

The basic purpose of the 1981 amendments was twofold: One, to improve the equitable relationships between claimants for regular unemployment compensation and individuals receiving extended benefits, trade adjustment assistance, and unemployment compensation for ex-service members; and two, to make such economies as could be accomplished while continuing to insure that benefits are directed to those for whom the law was intended.

Today I would like to discuss additional recommendations from the President to build on the reforms initiated last year and some related matters that may be of interest to the committee. As we engage in a dialog on these important unemployment compensation issues, it is important to keep in mind the four fundamentals of the administration's economic recovery plan:

One, lower taxes to stimulate saving, investment, work incentives, and productivity;

Two, control the growth of Federal spending, borrowing, and credit;

Three, decrease excessive and unnecessary Federal regulations;

Four, reduce inflation through a steady and moderate growth in the money supply.

Cooperation with Congress and with the independent Federal Reserve Board is essential to the long-term implementation of these fundamentals.

I would like to express my appreciation for the cooperation demonstrated by the Congress last year in putting in place phase 1 of our recovery program. Reforms contained in the Economic Recovery Tax Act and the Omnibus Budget Reconciliation Act were a necessary first step in implementing these policy fundamentals.

Within these broad policies it is also appropriate for me to reemphasize this year several themes that guide the administration's approach to reforming entitlement programs: One, remove disincentives and introduce incentives to work where possible; eliminate inequitable treatment of people in similar circumstances; reduce unintended and excessive benefits to recipients; target benefits to those most in need; improve efficient and effective management of program operations.

It is within this policy context that we have proposed three additional reforms affecting unemployment compensation and trade adjustment assistance for workers.

Before describing these proposals, I would like to comment on some concerns that have been brought to my attention about the ability of the present unemployment compensation program to meet the needs of rising unemployment. Unfortunately, unemployment is high and could go higher before recovery is evident. The concern is understandable but premature. I believe the basic program now in place is sufficient to address recession-induced joblessness just as it was intended.

Please keep in mind that we are estimating that a total of 11.5 million individuals will draw a total of $23.3 billion in benefits during the current fiscal year. In fiscal year 1983, 10.6 million individuals will be paid $21 billion in benefits, at an average weekly amount of $113.

In fiscal year 1982, all but a few States will trigger on 13 weeks of extended benefits, increasing benefit duration to 39 weeks in those States. In fiscal year 1983, we estimate that 22 States will be paying extended benefits.

In view of this large and flexible program now in place, Mr. Chairman, we do not need nor could we support any fundamental and costly changes that I am aware are being discussed. Reinstituting a national extended benefit trigger is unnecessary. About 46 States will trigger on this year, targeting the additional benefits to high unemployment States where and when they are needed.

A program of benefits beyond 39 weeks is unnecessary, given the path of the recovery that we see and given the present experience with claimants exhausting regular benefits.

Any delay in the effective date of the new extended benefit trigger enacted by the Congress last year would be unwise and would contribute to a larger Federal deficit. Postponement of 1 year would add $1.3 billion to the fiscal year 1983 deficit.

Reversing last year's reforms for unemployment compensation for ex-service members, UCX, would reestablish inequities, reinstitute incentives for people to leave the Armed Forces, and would cost an additional $240 million in fiscal 1983 and $240 million in 1984.

Removing the provision enacted by the Congress last year that requires borrowing States to pay interest on loans would reestablish the disincentives for States to adopt sound financing provisions in their State laws, would create additional incentives for States to borrow from general revenues, would worsen an already alarming insolvency problem in many State trust funds, and would add $393 million to the deficit in 1983 and $787 million in fiscal year 1984.

Now, Mr. Chairman, I would like to address 3 proposals for this year which will be transmitted to the Congress shortly. Under trade readjustment allowances, the Trade Act of 1974 provided adjustment assistance in the form of reemployment services, training, job search and relocation allowances and for trade readjustment allowances, cash benefits, to workers whose unemployment is linked to increased imports of foreign-made products. Our analysis of the program indicated that most workers eligible for trade adjustment assistance utilized only the cash benefits and made little use of the training or other adjustment benefits available to them. Of almost 1.3 million workers who received TAA from April 1975 through March 1981, only 38,000, that is less than 3 percent, entered training and only 1.2 percent completed training; one-third of 1 percent received relocation allowances. Thus, TAA has become primarily an income maintenance rather than an adjustment assistance program. This led to our proposals which were contained in the Omnibus Budget Reconciliation Act of 1981. These proposals represented a fundamental shift under the Trade Act. Major emphasis was given to employment services, training, and job search and relocation services rather than income maintenance.

To summarize, the problem with the old TAA programs was that TRA—cash benefits—provided incentives for prolonging the duration of unemployment. In contrast, last year's proposed changes provide incentives and assistance for unemployed workers to actively search for a new job. Thus, the TAA program will work to reduce rather than increase the unemployment in some industries.

We propose additional steps in this direction for 1983, and the trade adjustment assistance will be increased and TRA decreased.

Funds for adjustment assistance were raised to $25 million for the 1982 fiscal year. These funds will provide unemployed workers in 46 States with training, job search and relocation services. This level of funding is three times higher than funding levels in the last 2 years.

Payment of TRA would be eliminated for individuals not actively engaged in a training program on July 1, 1982. Those already in approved training would be permitted to finish their training under the provisions of the current law, and would receive TRA weekly benefits and training costs until training courses are completed.

This proposal would save, for the remainder of fiscal year 1982, $26 million; fiscal year 1983, $108 million; and fiscal year 1984, $81 million.

The second item is unemployment compensation for ex-servicemembers. One of the reforms undertaken in the Omnibus Budget Reconciliation Act of 1981 was to revise the eligibility requirements for UCX, effective for separations from service beginning July 1, 1981, to deny payments to individuals who separated from the military under honorable conditions and who had the opportunity to reenlist. While not so intended, this change resulted in the continuance of eligibility for individuals who were discharged under honorable conditions and whom the military does not wish to retain, such as those with a record of disciplinary infractions or who failed to maintain requisite skill proficiency.

The proposed amendment would limit eligibility for UCX to those individuals separated for such reasons as disability incurred while in the service, demobilization, or reduction in force. Those individuals involuntarily discharged under honorable conditions but whom the military does not wish to retain would not be eligible for unemployment compensation. The legislation, effective for those discharged on or after July 1, 1982, would reduce outlays by $5 million in fiscal year 1982 and by $30 million in fiscal year 1983.

The third item, Mr. Chairman, is to round unemployment compensation weekly benefit amounts to the lower whole dollar amount. As part of the general reform of Federal entitlement programs, this legislation would amend the Federal Unemployment Tax Act to require that State unemployment compensation laws provide, with respect to an individual's weekly benefit amount in any case where the individual's weekly benefit amount is not a full dollar, the rounding down of that amount to the closest whole dollar amount.

The proposal would apply to individuals whose benefit years began after June 25, 1983. It is not intended to impact on current unemployment compensation claimants. Any loss to an individual claimant would be minimal since with inflationary effects upon

wages, the average weekly benefit amount continues to rise from year to year. Savings realized by this proposal would impact positively upon the unified Federal budget and would reduce costs by $6 million for fiscal 1983.

Thank you, Mr. Chairman. This completes my formal statement. We would be pleased to try to answer any questions you or the committee may have.

Chairman ROSTENKOWSKI. Thank you, Mr. Secretary.

Last year, Mr. Secretary, in your testimony, there were rosy predictions under the President's economic recovery program about the projected rate of employment. In July 1981 the unemployment rate rose to 7.2. In December, it increased to 8.8. Today, the unemployment rate is 8.9 percent.

Now, this concerns everyone, Mr. Secretary. Give me your answer to where the jobs are. What has happened?

Secretary DONOVAN. Well, we are in a recession, obviously, Mr. Chairman. Where are the jobs? There are, on a positive note, some 270,000 jobs, I am informed, at the employment service every month that go unsought after. I do not know precisely all the reasons why, but in these days of high unemployment, it does seem to be an anomaly. But we were wrong in those projections last year.

As you are aware, our projection for 1982 is an unemployment rate of 8.9 percent, and I am told it is almost coincident with Ms. Rivlin's assessment. The jobs are not there, is the basic answer to your question, and without economic recovery they will not be there.

Chairman ROSTENKOWSKI. Well, we had a meeting the other day. It was a discussion about unemployment compensation, Mr. Secretary. I know that you come out quite strongly against doing anything in the unemployment compensation area. What troubles me, however, is the situation in which Michigan has found itself where enough people went off the 26 weeks to get onto 39 weeks. Because they went off, they are no longer considered a statistic. Not enough came on the unemployment rolls. Now, they are in a state of limbo where they are off the benefits of unemployment compensation. Anybody coming on line is off for a period of 13 weeks.

Do you think that is fair?

Secretary DONOVAN. I am not sure of the fairness. It sure is sad. Because of the formula, yes, Michigan triggered off——

Chairman ROSTENKOWSKI. What I am afraid of Mr. Secretary, is that you will find other States falling into that same camp. We do not know. As we expect, Illinois will come on in April, and because of the new level that would take place in September, it could very well go off. Then they would have to suffer for a period of 13 weeks or they would then no longer qualify for unemployment compensation. These are people that are not playing any game. I think the vast majority of these people really want to work. It is devastating to a family not to be able to at least have subsistence. I think that is cruel.

Secretary DONOVAN. We estimate in Michigan, by the way, Mr. Chairman, that the extended benefits will trigger on the week beginning February 28. If either of my associates want to comment further on your point of other States finding themselves in that position, I would welcome it.

Mr. LEWIS. Mr. Chairman, because of the mechanics of the calculation, as the Secretary indicated, Michigan did slip below 5 percent insured unemployment rate for the week of November 7, and the law requires that they be off for 13 weeks once they trigger off.

Chairman ROSTENKOWSKI. But that formula took place in the reconciliation bill of last year, did it not?

Mr. VAN ERDEN. Part of the change that we made in reconciliation to change the way the calculation of the rate is done did cause Michigan to trigger off this year, that is true. However, in the 11 years of the history of the program, I believe that this is probably the only time a State had high unemployment dip down for a short period of time and had to stay off 13 weeks. It is not a very common occurrence in any sense.

Chairman ROSTENKOWSKI. Even though it is not common, I think it is quite unfair for people not to be able to qualify because they are in that 13-week period. I think that members of this committee are very concerned about that. If it has happened once, it is certainly the opinion of many people here that it should not happen again.

Mr. Duncan will inquire.

Mr. DUNCAN. Thank you, Mr. Chairman.

Thank you, Mr. Secretary, for your appearance. I understand that there are a number of State unemployment funds which are facing possible insolvency problems. Would you care to comment as to the seriousness of the situation and any solutions that should be considered by this committee or anyone else to solve the problem?

Secretary DONOVAN. Well, you put your finger on something that has us extremely concerned. The debt to date is $6.6 billion, and I understand by the end of fiscal year 1982 it will be $9.2 billion. There has to be, and I think the Congress addressed it last year, more incentive for the State to balance its revenues and its outlays in these programs.

We have suggested and the Congress has acted on the interest that will be paid at a maximum of 10 percent beginning on those debts that are incurred after April 1982. I think this is an incentive. But you put your finger on a very, very serious problem, and with those comments I would turn to either Bert or Jim to comment further.

Mr. LEWIS. Mr. Duncan, as you know, the States have the authority under their laws to make modifications in their requirements that would bring about solvency in their trust funds. Many States now have a taxable wage base above the Federal requirement of $6,000. I believe 20 States already have taken action to raise their wage base. On the revenue side another alternative would be to look at the tax rate and see what they may have to do there in combination with the wage base.

More importantly, also on the revenue side, we think it is very important that States take action to reduce overpayments, and we have reason to believe that in some cases that proportion could be sizable, and we would like to see them strengthen the work search requirements in their laws.

Mr. DUNCAN. Strengthen the what?

Mr. LEWIS. The work search requirements. About 14 States acted on their own this year to strengthen the so-called work test in their

own State laws in the basic 26-week State program. We would also like to see greater reference by the job service in attempting to place UI claimants in jobs. I think those are things that the States can do and they have the expertise and are aware that they have these options. We help them where we can.

Mr. DUNCAN. How many States are in trouble on their unemployment fund? How many States are in trouble right now?

Mr. LEWIS. Right now 18 States are the ones that account for the $6.7 billion that the Secretary referred to. We will have probably 22 States in a net loan situation in 1983. There are States beyond that are on shaky grounds, but that is an acid test.

Mr. DUNCAN. Thank you very much, and thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Guarini will inquire.

Mr. GUARINI. Mr. Secretary, we welcome you. The State of New Jersey takes great pride in your accomplishments and service.

Secretary DONOVAN. Thank you, Frank.

Mr. GUARINI. The greatest problems I find in any of the polls I have seen that we have in our country on budget deficits and inflation, et cetera is jobs. This is what the people are most concerned with. Now, I understand that there is an 8.9-percent jobless rate today, but that does not really include all the people who have gone from unemployment into welfare, and does not track down the true rate of the unemployment. Is that a fair statement?

Secretary DONOVAN. There are the so-called discouraged workers, Congressman, I am certain, that are not reflected. I do not know what that number is, but certainly——

Mr. GUARINI. If a person goes from unemployment to welfare, is he still carried in the statistics as being unemployed? Do we lose track of people in our statistical way of keeping track of the status of people?

Mr. VAN ERDEN. Congressman, if the individual is looking for work he would still be counted in the total unemployment rate. He would not be counted in the insured rate, which is a measure of individuals who are getting unemployment compensation. We do lose him at the time he exhausts.

Mr. GUARINI. But we have no idea how many people we are really talking about? He just fades into the background?

Mr. VAN ERDEN. We do know something about the characteristics of exhaustees, and we know that as many as 60 or 70 percent return to work within 3 weeks of exhausting their unemployment benefits.

Mr. GUARINI. The highest category that we have of the people who are unemployed are the minority youth. I understand their unemployment rate is very high; is that correct?

Secretary DONOVAN. It is about 42 percent, I think, Congressman, with minority youths. It is a national tragedy.

Mr. GUARINI. Is there any kind of a program that the administration could implement in order to attack this problem? Most of the crime we have is, statistically, among our youth. I am just wondering whether or not, if we could find some kind of a solution for the unemployed youth, particularly the minority youth, whether we would be doing our country a great service.

Secretary DONOVAN. Yes, sir. You the Congress and we the administration have a historic opportunity to rewrite CETA and we are well on our way to finishing a CETA-proposed bill that we will be presenting to the Congress, and it attacks that very problem in a very focused way.

Mr. GUARINI. We will be getting a proposal on that? The administration is mindful of it and we will be hearing from you regarding some kind of a job program for our young people.

Secretary DONOVAN. Extremely mindful, and I just remind everyone that when CETA began, that unemployment rate that you and I are discussing right now was called a national tragedy and it was at 28 percent. Despite well-meaning legislation and dollars, we have gone backward.

Mr. GUARINI. Gotten worse.

Do you eventually want to get rid of the TRA? Do you want to repeal the TRA? I notice we have been sliding backward. Is it turning into a training program only?

Secretary DONOVAN. Basically that is correct. We truly believe that for these displaced workers there has been an incentive not to seek training and possible relocation, and, if you would, to accept, and this is a very terrible thing for an unemployed person, to accept psychologically that the job they are laid off from will no longer be theirs. That hope that is everlasting in their minds, and between that and the cash benefits I believe they have not sought the available training under the law.

Mr. GUARINI. Where there is an import problem, will there always be room for TAA to be given to people who are willing to be trained and willing to relocate?

Secretary DONOVAN. Yes; I believe there should be, but I also believe that people in similar situations, no matter what the cause of their unemployment, should be treated similarly.

Mr. GUARINI. Last, regarding the 13 weeks' extension which has been talked about a great deal in Washington, extending the present 26 weeks for another 13 weeks, if we are coming out of a recession, which we all state we are, whether it is the CBO or the administration, what would be wrong with extending these additional 13 weeks even on some restricted basis so the person does not get thrown onto welfare, does not lose the respect of his community and his family and can actually be given that extra hand because he is in a recession that has been forced upon him?

Many of these people want to work but cannot work. Why take dignity away from them? Why not for the sake of the other billion dollars that it would cost, give them a 13-week extension?

Secretary DONOVAN. The extended benefits trigger will go on in our estimation by our actuarial studies for 46 States, which will in essence extend those unemployment benefits, those extra 13 weeks. We believe that if our projections are correct, the extended benefit portion of unemployment compensation will carry us far enough so that the recession will start to get behind us, and resurgence and the economic recovery will begin. At least that is my hope.

Mr. GUARINI. Hopefully. Thank you. I see my time is up.

Mr. JENKINS [presiding]. Mr. Pease will inquire.

Mr. PEASE. Thank you very much, Mr. Chairman.

Mr. Secretary, first I would like to commend you for your announcement this week, I believe, that you were making $25 million available for job relocation and job search for the rest of this fiscal year.

Secretary DONOVAN. Thank you.

Mr. PEASE. That is a step in the right direction. I must say at the same time that there has been a little slippage between what you are able to provide this year and promises that you made last year. Just about this time last year in this hearing room on the record you said, "TAA training should be the one area that is accentuated." Mr. Lewis was even more specific: "Upon the enactment of the TAA legislation, the Reagan administration would come forward with a budget amendment and indicate under which authorities it would want $112 million to be available for TAA, job search training and relocation."

Further assurance was provided during the markup of the TAA legislation last May when Congressman Vander Jagt, the ranking minority member of the Trade Subcommittee, said in reference to TAA training that "The Reagan administration is perfectly willing to make the commitment in whatever form they can that $112 million of this money will go to training and there will be no broken promises as far as that is concerned."

Can you tell me on what date the administration requested the additional $112 million?

Secretary DONOVAN. We requested it, as I understand it, during reconciliation. It was dropped from $112 million to $25 million, and we are disappointed.

Mr. PEASE. That is contrary to my understanding. I understand that you did not request the funds until September 30, which was after the reconciliation bill was adopted.

Secretary DONOVAN. Well, I have a misunderstanding. I truly believe we asked for the $112 million, but we could be wrong. Can you help me there, Bert?

Mr. LEWIS. The exact date of when the request was forwarded by OMB we would have to get for the record, Mr. Pease. I will say that the administration continued to support $112 million until the President's September budget revision was presented to the Congress, which was the so-called 12 percent across-the-board cut revision. That $112 million was reduced to $98 million but was nevertheless supported by the administration formally as late as 1 week before the third continuing resolution was adopted by the Congress, and as you know, that $98 million was reduced by the Senate to $50 million and ultimately it came out of the third continuing resolution at $25 million.

The administration never backed off of its support for the $98 million.

Mr. PEASE. Can you provide me for the record with any request that you made in writing to any congressional committee for the $112 million if such a request was made prior to September 30 of last year?

Secretary DONOVAN. We will.

Mr. PEASE. Thank you very much.

Now, I am a little troubled in your testimony that you seem to imply that unemployed workers, specifically auto workers, in my

case, did not bother to apply for training or job search, or relocation funds, which I think carries the implication that all they are interested in doing is collecting the weekly benefits and to heck with the rest of it. Yet in your testimony you also mention that the amount of TAA funds that you are requesting for this year, you are making available this year $25 million, is three or four times as much as has been provided in any prior year.

Isn't it quite possible that unemployed workers did not make greater use of the TAA funds because none were available, or at least no more than token amounts were available?

Secretary DONOVAN. No; I do not think that is the case, Congressman. I truly believe that the training and relocation and counseling features of this program were not adequately used, not because they were only interested in the cash benefits, as you say, but because, as I tried to say to Congressman Guarini, it is a very difficult thing to come to a conclusion that you need retraining and maybe relocation.

I think there are many reasons why that feature of the program was not taken advantage of, but the $25 million is three times higher than previously available. I think the highest in the past was $17 million, and the lowest was $3 million or $6 million.

Mr. PEASE. That is understandable, but your own department's fact sheet showed that some 90-odd percent, 94 percent of the workers in training in fiscal 1981, last fiscal year, had to pay for their own training because there was not any money available. Would not that have discouraged more people from applying for TAA training funds?

Secretary DONOVAN. Bert will answer that. Thank you.

Mr. LEWIS. Mr. Pease, the long-term figure for the proportion of TRA claimants taking up training was 3 percent, as the Secretary indicated. That is over a period of from 1975 through 1981, I believe. Last year, as you know, the Trade Act program was linked to the UI program, and the benefit amount was reduced to equal the state UI benefit amount. We did see considerable increase in interest last year in training, and your comment is correct, there were about 20,000 TRA claimants who entered training in 1981, and I think about 593 of those enjoyed federally financed training and the rest did pay for training themselves.

So I think the new design that began to go into effect last year is beginning to show some of the things we had hoped for. Unfortunately, we did not have very much training money in 1981. A maximum of $8 million was available and there was really none available in the first quarter of this year. We will be getting some experience now that these $25 million have been allocated and the training system gets cranked up again to really see what the true takeup rate is going to be, and frankly, it is hard for us to predict.

Mr. PEASE. Thank you. My time has expired. I hope I will be able to get back with some additional questions later.

Chairman ROSTENKOWSKI. Mr. Moore will inquire.

Mr. MOORE. Thank you, Mr. Chairman.

Mr. Secretary, I agree with your admonitions on page 4 and 5 of your testimony. I certainly hope the Subcommittee on Unemployment Compensation of this full committee will not back away from

the, I think, improvements we made in the unemployment compensation program in 1981 as part of the reconciliation bill.

We have backed away in the one instance of the unemployment compensation for ex-servicemembers. That has not become law yet, and I am pleased that you are proposing as your second proposal additional language to clarify what some members believe to be an inequity that we can hopefully lay to rest.

Mr. Secretary, there is something that was not covered in your testimony that I would like to ask you. On page 3 you indicate that in the dialog on unemployment compensation, as a third point, you hope to eliminate inequitable treatment of people in similar circumstances.

We in the Unemployment Compensation Subcommittee worked with last year and did not complete, and I would hope the full committee would consider this year looking at the tax exempt status of unemployment compensation benefits coming to a recipient. I believe it is $20,000 now on a single taxpayer's return, and $25,000 on a joint taxpayer's return.

It appears to me that with two people living next door to one another, one earning $25,000 a year and paying income tax, presumably, on that full amount, and one receiving unemployment compensation benefits, a joint couple paying nothing on $25,000, that that is, in fact, inequitable treatment of people in similar circumstances.

I wonder what your thoughts are on that and what your opinion would be if this committee moved to remove or lower that threshold.

Secretary DONOVAN. Congressman, thanks for your compliments on page 4 and 5 on our stick-to-itiveness. But on taxing unemployment insurance benefits, the administration has no proposal this year. As you pointed out, there are pros and cons connected with this proposal. I would say for this year we have no intention to address it. Philosophically, you make a good point. But we have our plate full at this time and would not be entertaining it.

Mr. MOORE. There is no opposition to it at this point. If this committee came forward with that, we would not expect it to be opposed by the administration?

Secretary DONOVAN. I am sure there would be pros and cons in the administration on it, Congressman Moore.

Mr. MOORE. Thank you. Mr. Chairman, no further questions.

Chairman ROSTENKOWSKI. Mr. Anthony will inquire.

Mr. ANTHONY. Thank you, Mr. Chairman.

Mr. Secretary, after the recession abates and we do start moving towards more incentives for employment, and as businesses start using up their unused plant capacity and they start thinking about expanding and employing more, it appears to me that we are going through a transition in the United States into high tech industry and to more service-oriented industry.

There seems to be a subtle changing coming on board. And I just wonder what, if anything, you are doing within the Labor Department to anticipate that, to work towards that, to try to provide the necessary skills in the workers that are going to be needed if in fact that does come into play.

Secretary DONOVAN. Congressman Anthony, I agree with you wholeheartedly, and I think it is more than a subtle change coming. I think it is coming somewhat more rapidly than others would believe. If you would recall, in the 1960's there was a great fear of displacing workers, and sociologists even used the word—and it is a horrible word—"redundant workers."

But it did not happen. Technology came, but it did not happen, because the economy was growing and was able to absorb them. But with the technological changes and the robots that are coming on line now, and the stress of moving into the service industries, there is a major problem that we are going to face in the late 1980's and early 1990's.

The demographics of the whole work force has to be and is being studied. The administration recognizes the displaced worker problem, but we have little experience with it in training. To the degree that we do, the Down River project in Detroit indicates some successes and could, if it continues to develop the way it is, be a pilot project for industry and labor.

And from my point of view, I see this displaced worker problem as primarily an industry and labor problem, to be settled at the bargaining table, with Government involvement, yes, but I believe only at the margins. But it is something that is serious and it is not too early to address it, and we are studying it.

Mr. ANTHONY. Well, I guess what bothers me is the cause. Like in my State, only 47 percent of the graduates from high school go into post-secondary education. That includes vocational schools. Yet vocational schools do play a strong part not only in the South, but throughout the United States, in trying to teach some of these specific skills.

As I look through all the areas of the budget, I really find some strong contradictions. You say that you recognize that you are going to study it, and you hopefully would be able to address it. But if I understand it correctly, the vocational education budget, for instance, takes a 43-percent reduction from fiscal year 1982, and there was a 17-percent reduction from 1979. So just in that one small area alone you are seeing the Federal Government basically say, well, it is not our problem, it is someone else's problem.

And I guess I am asking you, what is the philosophy within the Labor Department as to whose responsibility is it to provide some of these job training programs? Do we have a national job training policy, or should it rightfully go out to the 50 States?

Secretary DONOVAN. We do have a national policy, as I indicated earlier in my comments to Congressman Guarini. Under the rewrite of CETA, it is a $1.8 billion project. We are excited about the potential of it. We have learned a lot in America. A high tuition was paid—$53 billion over 7 years in CETA—to learn. But we are focusing—and it is a national project—on training in the private sector.

It is not the displaced workers I am addressing now; it is the hardcore unemployed youths who not only have failed their second try, but whom we want to give a third attempt to get out of the safety net. It is a national program. It is one I know we are proud of and I hope the Congress is.

Mr. ANTHONY. Mr. Chairman, with your indulgence, one, just one final question. It is my understanding that the administration is also proposing a change of policy from last year. Last year we said we are going to encourage the States to go into community work experience programs or workfare for AFDC recipients. Now this year we say we are going to make it mandatory. So we have had a shift of opinion from last year to this year. Last year it was optional and this year it is going to be mandatory.

Will you have anything to do if those programs are made mandatory, or will that strictly be left up to the States to implement?

Secretary DONOVAN. That would come under HHS.

Mr. ANTHONY. So you actually would have nothing to do with that?

Secretary DONOVAN. A keen interest in it, but no direct program authority over it.

Mr. ANTHONY. Well, under previous experiences where they had these pilot projects, one of those fell under your Department?

Secretary DONOVAN. Oh, Congressman, we had pilot projects coming out of our ears over the past 7 years in CETA.

Mr. ANTHONY. And I take it by your expression almost that you did not think those worked?

Secretary DONOVAN. Well——

Mr. ANTHONY. Did they work?

Secretary DONOVAN. I will put it to you this way. I think we tried to reinvent the wheel and we wasted a lot of money in a lot of those projects.

Mr. ANTHONY. Then that really leads me to my final question. Do you not have some experience, then, in a mandatory workfare program project or pilot project that you could share with another agency of the Federal Government that would like to mandate it upon the States? In other words, could we not reinvent the wheel again under HHS, when you say we have already tried to reinvent the wheel through some of your projects? Is there some experience there that could be shared, so that we would not have the same problem?

Secretary DONOVAN. Yes. Under the WIN program there is, Congressman.

Mr. ANTHONY. Do you have this dialog back and forth so that you can share some of those experiences?

Secretary DONOVAN. Yes. There is a mechanism for that with us and HHS.

Mr. ANTHONY. Thank you very much.

Chairman ROSTENKOWSKI. Mr. Jenkins will inquire.

Mr. JENKINS. Thank you, Mr. Chairman.

Mr. Secretary, the administration has a proposal that will require the States to round off unemployment benefits down to the lower dollar amount, as I understand it. Can States do this now under their own initiative if they want to?

Secretary DONOVAN. I think yes, they can.

Mr. JENKINS. I am just curious as to why we should enact a Federal law requiring that States do this, when they now have the authority to do it. It would appear to me that it is somewhat in conflict to our general direction that we let States sort of run their own shop.

Secretary DONOVAN. Yes, I would say that that is a good observation about federalism. But I truly believe, although it looks picayune, and some hours I believe it is picayune myself, that with the trust fund being in the jeopardy that it is and with the Federal budget as stressed as it is, it is one way, minor though it may be—it is $6 million, I believe, in remaining fiscal year 1982—to help that budget deficit.

And it is not unique, I would say, Congressman Jenkins. It follows the rounding in the social security benefits and suggested rounding in AFDC and SSI and in DOD retirement benefits.

Mr. JENKINS. Emergencies sometimes require Federal intervention in State affairs, I guess.

Secretary DONOVAN. Especially invasions and things like that.

Mr. JENKINS. Let me ask you one other question on another matter. There are six or eight regional centers set up to provide technical assistance to industries that have been impacted by imports and so forth.

Mr. BAILEY. That is in the Department of Commerce.

Mr. JENKINS. I understand that is being phased out or being substantially reduced.

Secretary DONOVAN. I would hope not. I am not certain.

Mr. JENKINS. Is anyone on the panel aware of that? I will make an inquiry.

Secretary DONOVAN. From what I read, Mac Baldrige did quite well.

Mr. JENKINS. Tell him to check on the one down at Georgia Tech that has been doing such a great job. I would hate to see them totally out of work.

Thank you.

Chairman ROSTENKOWSKI. Mr. Vander Jagt will inquire.

Mr. VANDER JAGT. Thank you, Mr. Chairman. I would like to welcome the Secretary to the committee and let him know, we are glad to have you here and thank you for your testimony.

I yield back the balance of my time.

Chairman ROSTENKOWSKI. Mr. Downey will inquire.

Mr. DOWNEY. Thank you, Mr. Chairman.

Mr. Secretary, I would like to get from you some discussion on the new proposed employment and training block grant. Can you give us some idea of what is going to be in that employment and training block grant?

Secretary DONOVAN. It would be somewhat impolite if I got into too many details, Congressman Downey, at this stage, because we have not discussed it thoroughly with the Labor Committee. But it is a block grant to the Governors. In essence, and I do not want to state this too broadly, but in essence it takes the Federal Government out of the training business. This is focused, giving the Governors and in certain instances mayors, who are closer to the problem, the flexibility to attack what we consider to be a major blight on this Nation.

It addresses the training needs of AFDC women and the youths from 18 to 25, out-of-school dropouts. It will be private-sector oriented. And we are proud of what we are producing and we hope to get the concurrence of the Congress.

Mr. DOWNEY. Let me ask you about one of the proposed elements of the block grants that you intend to fold into the block grant, title V of the Older Americans Act. Is that correct?

Secretary DONOVAN. What was that?

Mr. DOWNEY. Title V of the Older Americans Act, that is going to be part of the block grant?

Secretary DONOVAN. That is why I am hesitant to be too specific. There is $200 million for national projects.

Mr. DOWNEY. Of which this is part, is that correct?

Secretary DONOVAN. No, that is separate, and so is Job Corps.

Mr. DOWNEY. So the title V is not going to be in the block grant?

Secretary DONOVAN. The treatment of the Older Americans situation will come from in part the $200 million for national projects, and we are discussing the flexibility of a limited amount of the funds from the block grant also. That is not yet determined.

Mr. DOWNEY. Is the level of funding as yet determined for the title V of the Older Americans Act?

Secretary DONOVAN. It is yet to be determined.

Mr. DOWNEY. May I read to you the testimony of an Albert Angrisani, I believe is the pronunciation of the name, one of the Assistant Secretaries of Labor, who testified before the Senate Committee on Aging:

> The President has a firm commitment to strengthen the services provided under the Older Americans Act, and the senior community services employment program contributes to that commitment.

Now, Mr. Secretary, I have gone to one of the senior community service centers in my district, one of the nutrition centers. These people are writing me letters about this program closing down. Now, 87 percent of these people have incomes below the poverty line, and their job primarily is to work in senior nutrition centers and help out in other community service endeavors. In many instances their meager salaries are less than $40 a month, and this makes the difference between whether these people survive or not.

Now, I would like to know, Mr. Secretary, whether or not I can go back and assure my constituents, six of whom were over the age of 80 and unlikely to find employment in the private sector, whether or not there is going to be a program for them after March. Now, can you give me some assurances that they are going to continue to work?

Secretary DONOVAN. There will be a program, yes.

Mr. DOWNEY. And I can tell the people in my district—and my county gets $1,036,000—that that basic level of funding will be continued, and that the certain number of people, I forget how many it is, about 500 in my county, will be working?

Secretary DONOVAN. I cannot be that specific at this time; no.

Mr. DOWNEY. Well, what can I tell them?

Secretary DONOVAN. That we are addressing the problem, that we recognize it and we recognize it as a major commitment of this administration.

Mr. DOWNEY. Do you think it is a good program?

Secretary DONOVAN. Yes; I say this: It does not belong in the Labor Department, in my view. It belongs at Health and Human Services. It is a transfer of dollars, not training.

Mr. DOWNEY. Yes, I understand. But whether it belongs in Human Services or in Labor, I have some support then from you and this administration that this is an important program that provides a service that this administration plans to keep? Is that a correct summary of your attitude?

Secretary DONOVAN. That is a correct summary.

Mr. DOWNEY. Thank you.

Chairman ROSTENKOWSKI. Are there any further questions? Mr. Bailey will inqure.

Mr. BAILEY. God bless you, Mr. Chairman, for catching me in time.

Mr. Secretary, I believe in your testimony—and forgive me, I just had a chance to review it—you commented that you would oppose changes in the military compensation.

Secretary DONOVAN. Yes, sir.

Mr. BAILEY. But you do intend to try to clear up the definitions?

Secretary DONOVAN. Yes, Congressman Bailey.

Mr. BAILEY. You realize the definitions cause an anomaly today, that is, folks that simply are perhaps not wanted and do not receive honorable discharges in some cases or less than honorable discharges can qualify for benefits, while someone who is reenlistment eligible or desired cannot. Your assistant and I have been around and around on this point before you are going to get those things cleared up. When are you going to get them cleared up?

Secretary DONOVAN. That is what we are suggesting here.

Mr. BAILEY. Well, in reconciliation you were going to have those changes made. You know, this desire to get these regs straightened out. The Department of Defense was supposed to help with this, and they have not been straightened out. This request to get this problem straightened out is not new, you know.

Secretary DONOVAN. We are making another attempt. It needs straightening out.

Mr. BAILEY. It is really not that complex at all.

Secretary DONOVAN. The Department of Defense is strongly with us on this issue. The proposed administration bill provides that an individual will be entitled to benefits only if he is involuntarily separated by the branch of service because he is physically or mentally unable to perform proficiently or because of a reduction in standing military——

Mr. BAILEY. I know what they say. It is just the effect that they have you acknowledge is unfair and you are going to try to get that straightened out?

Secretary DONOVAN. Yes.

Mr. BAILEY. OK. Why are you opposed to help for ex-servicemen? I had one case, for example, of an ailing father who had a young man in the service. He wanted to stay in the service, wanted a compassionate reassignment, and eventually had to separate.

He comes back to a nonexistent job market, has not had a chance to even look at that job market and not had a chance to enter it; no idea where to look, where to go. It really hits our disadvantaged youths, our minority youths, terribly. If they are not wanted for reenlistment, it is even worse for them.

Why do they have to be different? Because it is supposedly a voluntary thing? You are certainly not trying to force people into retentions, are you?

Secretary DONOVAN. Well, to the degree that it is comparable to someone leaving their job in the private sector; yes, it would be a voluntary separation. So to that degree there is a comparison.

But I think a more important one—and this administration or I would suggest any administration would see that—the dollars spent to upgrade the military and to retain the technical abilities of these people for our defense should be maintained, and anything that would create an incentive to leave, and this would be one, should be eradicated, in our opinion.

Mr. BAILEY. I respect your integrity. The first administration official who has actually admitted that that is exactly what it is, a desire to keep kids in the voluntary service. That is all that it is.

Secretary DONOVAN. What is wrong with that?

Mr. BAILEY. If that is some reflection on the spirit of voluntarism or what is fair to these kids, I disagree. I respectfully disagree with you. And I respect you for putting your finger on it, because that is what I suspected all the time.

It is nothing more than a desire, because of the need to keep people in the armed services, to affect a personal choice. And I just want you to know that I do not think it is fair, especially because of some of the personal problems some of those kids have.

Secretary DONOVAN. But Congressman, the dollars that are expended to educate our servicemen are investments in the defense of this Nation.

Mr. BAILEY. I am glad to hear you say that. I know you are going to help me with a bill I've introduced that hopefully will give the secretaries of the respective services the flexibility to go out and contract with community colleges to give people some up-front money to get skilled people, then put them on for 2 years. We can save 8 to 10 times the amount of money spent on training them and increase our skilled labor pool at the same time.

The way you are trying to do it with this mechanism here, I just want to tell you, I think is terribly discriminatory and unfair. It is unjust, and if you want to sign somebody up for 20 years because you invest in their skills then you ought to go right out and contract with them and sign them up for 20 years. But do not get them on variable terms of enlistment and then come in and induce them with bonuses, and get rid of the ones you do not want because you do not need that MOS and you need another MOS somewhere else.

My time is up, and I thank you.

Secretary DONOVAN. I am interested in your bill, because we are looking into that same area. I would like to come up and discuss that with you.

Mr. BAILEY. I will send a copy over to you. Thank you.

Chairman ROSTENKOWSKI. Mr. Ford will inquire.

Mr. FORD. Thank you, Mr. Chairman. Mr. Secretary, I too would like to welcome you before the committee. I am sorry I wasn't here to hear your testimony before the committee, but I do have it before me at the present time.

I would like to know how many of the unemployed workers in America today will be denied unemployment compensation benefits as a result of the amendments added to the 1981 Budget Reconciliation Act. Could you give us a figure, because when I go back and I look at these amendments—I am speaking of the national trigger in the extended benefit program—the individuals claiming extended benefits were excluded from the numerator as well as the effective September 21 date that will trigger in, I guess, in September of this year, which will be both the mandatory and the optional State extended benefit trigger rate.

How many people are we talking about?

Secretary DONOVAN. First, I would say that if the national trigger were on now it would not have triggered on at all up to date, nor through next August. But I would ask Jim to respond to your question. I think he can do it with some statistics.

Mr. VAN ERDEN. Mr. Ford, we estimate, under the new administration's economic assumptions, that approximately 1 million people in 1982 would be affected by those changes. By affected, I mean——

Mr. FORD. How many?

Mr. VAN ERDEN. About 1 million.

We are paying somewhere over 11 million people this year in the program. About 1 million people would have their EB—extended benefits—reduced. That doesn't mean they would be totally cut out, but they would receive at least 1 week less than they would have had the changes not been made.

The estimate for 1983, which includes the change in the national trigger, the change in the calculation, the new State trigger levels at 20 weeks of work, comes to some 3 million people that would be affected.

Mr. FORD. So, all totaled we are talking about some 3 million people. Is that correct?

Mr. VAN ERDEN. Yes, sir, that it would have some effect on.

Mr. FORD. Mr. Secretary, what do you say to those 3 million people who are out there somewhere in the wilderness of this country, or what can I say to those who are in my district? Or what can we say to those who are unemployed and are being denied the extended benefits? I am talking about the 13 additional weeks.

We have problems, and I am not from the State of Michigan, but now Michigan has triggered off.

Secretary DONOVAN. That was an anomaly. We discussed Michigan.

Mr. FORD. Well, I am not really talking about Michigan, but I am speaking of what do you say as Secretary of Labor for this Nation? What do we say to those who are unemployed in this Congress and this administration? Will this administration not have a sensitive ear to the hard core unemployed in this country?

Secretary DONOVAN. Extended benefits will trigger on this year in 46 States, Congressman.

Mr. FORD. How many States have triggered in as of today, Mr. Secretary?

Secretary DONOVAN. Twenty.

Mr. FORD. Twenty have already triggered in.

Mr. VAN ERDEN. And we anticipate that we will have at least 10 to 12 States on within 2 to 3 weeks—additional States.

Mr. FORD. Within 2 or 3 weeks?

Mr. VAN ERDEN. Yes, sir.

Mr. FORD. Well, that would give us a total of how many States?

Mr. VAN ERDEN. About 33. We are estimating 46 for the year, if our economic assumptions prove out.

Mr. FORD. What are these people going to do in the meantime if you have not extended the benefits and the people have already exhausted the 26 weeks?

Mr. VAN ERDEN. For those who have exhausted the 26 weeks there is nothing we can do until the EB trigger goes on. But many of the people who will be drawing extended benefits over the next couple of quarters are just now drawing regular benefits. They have not exhausted their regular benefits.

The exhaustion levels we are looking at, the number of people who are drawing final checks, has not risen appreciably in the last few months. In fact, it is below the 1980-81 levels and significantly below the levels we experienced in 1975. So we feel that the extended benefits will be triggering on just about the time that it is needed in those States.

Mr. LEWIS. Mr. Ford, the exhaustion ratios that the Secretary referred to in his testimony are being monitored carefully by us. That ratio is below what it was last May and we did not hear anyone recommending benefits beyond 39 weeks then or modifying the triggers.

The number of people exhausting regular benefits in December was significantly below those exhausting the previous January, February, March, and April. We did not hear anyone requesting a program like that then. So those are one of the measures we are looking at.

Mr. FORD. Well, say if there are 40-some States that will trigger on within the next few weeks or months or what have you. What about the effective date of September 25, 1982, where both the mandatory and optional State extended benefit trigger rates, how many will trigger off after the September 25 date?

Mr. VAN ERDEN. Mr. Ford, we don't know exactly how many would trigger on that date. We do know in our projections that seven fewer States would be on next year because of the change—that is, you know, if the 1983 projections hold up.

Mr. FORD. Are those projections showing the 40-some States triggering in before the September 25 date?

Mr. VAN ERDEN. Yes, sir. The rate that triggers the States on is not seasonally adjusted.

Mr. FORD. I understand. But in your projections you have just indicated that you are not sure how many States will trigger off after the September 25 date. What do your projections show for those who have triggered on prior to?

Mr. VAN ERDEN. Well, Mr. Ford, what happens is that a lot of States will trigger off because the unemployment rate falls in the summer months.

What I was saying was I don't know exactly how many would go off on October 1. I do know, making year-to-year comparisons, that seven fewer States would be on. I have no way of actually knowing

exactly the number that would go off on October 1. I would assume it would be in the neighborhood of 5 to 10 states who might be on at that time.

Mr. FORD. Mr. Secretary, if things continue to get worse with the unemployment problem in this country, do you, as Secretary, plan to respond in a fashion that—and I think some of my colleagues have already talked about—training funds or moneys in relocation—you know, moneys that would be available for the unemployed in this country?

Do you foresee any recommendations at all going to the White House in making it very clear that we have unemployment today at 8.5 and the projections are that within the next couple of months it will exceed beyond the 9-percent level? Do you have any plans in your offices there to talk with the President and other Cabinet members or Mr. Stockman, for one?

Secretary DONOVAN. Are we speaking in the unemployment area?

Mr. FORD. Yes; I am.

Secretary DONOVAN. We are constantly monitoring a number of indicators. As an example, if for any reason the current economic assumptions are wrong, you can bet that we will be back at the White House pointing that out and having them recognize that those assumptions were wrong.

The rate of exhaustions we are watching as to individual claimants. The exhaustions of extended benefits, the impact of extended benefits on people's work search pattern, that is being watched. And just how any new program would impact on the Federal deficit and the budget, that has to be considered.

And if there were to be a State sharing of the cost, with the current status of the State trust funds with respect to their solvency, all of these areas are very much in our mind.

Mr. FORD. One final question, if you do not mind, Mr. Secretary. You mentioned on page four:

> In view of this large inflexible program now in place, Mr. Chairman, we do not need nor could we support any fundamental and costly changes that I am aware are being discussed.

If at such time you, as Secretary of Labor, felt the need to respond to the unemployment problem in this country by going to the President or Dave Stockman and saying to them that we need some emergency legislation right away and if there were two options placed before you—the extended benefits, whether we are talking about all of the State triggering in now under the new State triggers or training moneys and relocation moneys—would you support the additional 13 weeks, going beyond 39 weeks?

We're talking about an additional 13 weeks of unemployment comp. Or would you be willing to support training moneys and relocation moneys?

Secretary DONOVAN. We would have to determine at that time, and my previous answer and the points raised in that answer would have to be considered.

From a personal point of view, training, to me, despite the poor experience of the CETA programs, many of them— there were some successes, but there were some abysmal failures. We talked

about one earlier with Congressman Guarini. When CETA came in minority unemployment was at 28 percent and it was called a national tragedy. You know what it is today. It is in the mid-40's.

Training and education is the final answer and not supplements, wage supplements, in my view. But you can't ignore either a person's obligation to feed the family in the short run. But if I had my druthers I would put it into training, in meaningful private sector employment.

Mr. FORD. Well, you say you can't ignore either of the two that I mentioned.

Mr. Secretary, you know for yourself that in urban areas like mine in Memphis and other urban cities throughout this country black unemployment among teenagers is way over the 40 percent mark. And if you look at the overall black unemployment in this country, you know, and relate that to the present scale of unemployment, which is too high, then we would see that this administration or the Labor Department is not responding to the unemployment problem that minorities in this country are now faced with, nor are you responding to the unemployment question that is before the American people today, and that is that you have millions of people who are out of work.

Secretary DONOVAN. I disagree with you. We are addressing the minority unemployment in a more specific---

Mr. FORD. You cut the comprehensive employment and training program out. You have cut out every jobs program that has been in existence for minorities in the last 5 or 10 years. This administration has refused to come to this Congress and let us evaluate some of those vital and important programs prior to any action of any proposed budget cuts that have been before us in the last Congress, under the budget reconciliation and even the proposed cuts that are being placed before us today.

Secretary DONOVAN. That is too broad a statement and too broad a criticism, Mr. Ford. I disagree, and when you see our CETA package I don't think you will make the same statement.

Mr. FORD. Well, maybe not. From what I have seen so far I do not think I would change my mind.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Guarini will inquire.

Mr. GUARINI. No further questions.

Chairman ROSTENKOWSKI. Mr. Pease will inquire.

Mr. PEASE. Thank you very much, Mr. Chairman. I appreciate the chance to finish my line of questioning.

Mr. Secretary, would you tell us how far the $25 million will go toward meeting the need for training, relocation and job search in this fiscal year?

Secretary DONOVAN. In the numbers of people affected?

Mr. PEASE. Yes. How many people will be seeking those funds for either training or job search or job relocation?

Secretary DONOVAN. We are trying to determine how many will seek. From past experiences we believe that it would be adequate for this year. I think we will be able to train 5,700 using a per capita of around $3,500 or $3,700 per individual.

Mr. PEASE. So it is your feeling that the $25 million will make funds available for each person that you anticipate will seek job training or relocation or job search in this fiscal year?

Secretary DONOVAN. No. I am not comfortable at $25 million, no. I would say we would not be able to satisfy every request.

Mr. PEASE. What percentage? I understand that you do not know how many requests there will be and there is a bit of guessing going on, but what percentage would you expect to be able to satisfy with the $25 million?

Mr. LEWIS. Probably—we are estimating there would be about 70,000 to 74,000 individuals drawing TRA benefits, so somewhere in the neighborhood of 10 percent of the total. It will be a much higher percentage of the some 30,000 new eligibles that we estimate will be coming in during the year.

I think the important thing is, as the Secretary indicates, we do not know how many people will express interest in training. We believe we can train just under 6,000. That has to be looked at in comparison to the 600 that were trained with Federal funds in the last year of the Carter budget and the 1,800 people who were trained with Federal funds in the year prior to that.

So while the $25 million is not what we asked for and it may not be enough, it is a heck of a lot more than we were able to do in the prior 2 or 3 years.

Mr. PEASE. Well, I appreciate that. But I gather from your response that you would anticipate that some time before September 30 of this year—May, June, July—the State employment offices would have to start telling applicants that they could no longer get Federal funds. Is that right?

Mr. LEWIS. We just don't know what the timing of that would be.

Mr. PEASE. OK. Would you be inclined to request additional funds for the remainder of this fiscal year if the demand is there?

Secretary DONOVAN. Would I be inclined? Yes.

Mr. PEASE. I am glad to hear that.

Finally—well, not finally, but you are planning, apparently, in the next fiscal year—fiscal year 1983— to lump in funding for TAA training with other special target groups—older Americans, migrants, Indians, displaced homemakers, et cetera. It is unclear to me whether you are asking for $200 million total or $200 million plus $94 million. Could you clarify that for me?

Secretary DONOVAN. I believe the total package is $200 million, Congressman.

Mr. PEASE. Do you have any notion of what percentage of that $200 million would go for TAA training?

Secretary DONOVAN. We are trying to decide that now and make our feeling known to the Congress. It is a very difficult area to spread that money.

Mr. PEASE. You are consolidating several different existing programs. Do you have any idea what the current appropriation is for all those programs? In other words, does the current appropriation for fiscal year 1982 total $200 million, or is it $300 million or $400 million?

Secretary DONOVAN. I don't know. We will get it for the record, Congressman Pease.

[The information follows:]

Budget authority requested for those programs in fiscal year 1982 totaled $252 million and the budget outlays expected in fiscal year 1982 are $576 million.

Mr. PEASE. Finally, if I may, Mr. Chairman, I would like to comment on a couple of things.

In your testimony, Mr. Secretary, on page 4 you say you do not need, nor could we support, any fundamental and costly changes in unemployment compensation. Then you say a program of benefits beyond 39 weeks is unnecessary, given the path of the recovery that we see and given the present experience with claimants exhausting regular benefits.

The workers in my area, where the unemployment rate is 18½ percent, are now into the 13-week supplemental. They will be exhausting that, most of them, by the first or second week in January—excuse me, in April of this year. What is it about the path of the economic recovery that you see which makes you think that those workers will not be in any need for benefits beyond April?

Secretary DONOVAN. That's a very good question. The recovery will only be beginning by April and hopefully heating up through the summer and marked improvement by the fall. There is no question that those people, if they are exhausting their benefits, are going to be hurt.

Mr. PEASE. Then why would you say that a program of benefits beyond 39 weeks would be unnecessary?

Secretary DONOVAN. I was talking from a national point of view. The exhaustion rate, as Mr. Lewis indicated, is about 32.4 percent, the same rate as a year ago and almost the same rate as the prior year. That is nationally.

The economy is expected to begin to improve when most people will still have those EB benefits available to them. In your State it wouldn't be true, but Bert would like to add to that answer.

Mr. LEWIS. Mr. Pease, beyond the comments on the national overview I think that, first of all, cost considerations need to be paramount in looking at a program beyond 39 weeks. And by illustration, just for a 6-month program—say the balance of the current fiscal year—a national FSB program modeled after the prior FSB program would add $1.5 billion to the deficit that everyone is concerned about.

Also, I think one needs to consider carefully the impact on labor market behavior, and while we do not have national samples on this, there is anecdotal information from some States taken on a State valid sample basis, that would indicate fairly startling things.

For example, in a couple of States where we looked at the information recently, you find that among exhaustees perhaps a third drop out of the labor force after they stop drawing benefits and perhaps as much as two-thirds, strangely enough, find a job within 4 weeks after exhaustion. So I think one needs to look at that issue very carefully, and that's why the Secretary has concluded it is really premature.

Mr. VAN ERDEN. Mr. Pease, there is another issue. It is that even in very good times we have about 25 to 30 percent of the claimants exhausting the regular program. In your State, for the calendar year ending December 31 last year, the rate was 32.6 percent. Now those individuals that exhaust that would go into extended benefits beginning in January.

So I would assume that the exhaustion rate is below 30 percent for those in the EB program now, which is very similar to what we would experience in relatively good time. So the point is we are always dropping people out of the program. That is the very nature of the short-term insurance program we have. But what we try to do is look at a way to reduce that exhaustion rate in periods of high unemployment, and the EB program appears to be doing that right now.

Mr. PEASE. Well, I appreciate that and understand it. I also understand the fiscal impact. I was just intrigued that the Secretary gave as a reason that it was unnecessary, given the path of recovery that you see. I was just wondering if you saw something that the rest of us did not see, but you do not. You do not think the recovery will be blossoming upon us within the next month or two.

Secretary DONOVAN. No, I don't.

Mr. PEASE. Finally, Mr. Secretary—and this will be my final comment—going to the question of servicemen and your plan to cut off those from unemployment benefits who are honorably discharged but whom the military does not wish to retain, it boggles my mind that the administration would propose dropping those people from eligibility for unemployment compensation.

Surely if anybody would meet the classic definition of people who are unemployed it is servicemen who want to continue in the service but who are involuntarily dropped out of the service. What is the rationale for that?

Secretary DONOVAN. Well, the inequity that we are trying to cure by making this suggestion is that someone who leaves with an honorable discharge, but whom the military does not wish to keep, has benefits available to him, while those the military wishes to keep do not. I think, Jim, maybe you can add to that.

Mr. VAN ERDEN. Mr. Pease, there is a point on Mr. Bailey's example earlier where you talk about a voluntary quit. An individual has to leave the service to return to his hometown to take care of his family. If an individual is employed in the private sector in another State and quit his job to return home for the same circumstances he would not be eligible for unemployment insurance in that situation either. So there is an equity situation there in terms of those who voluntarily separate.

Do you pay them under one situation and not under the other?

Mr. PEASE. This is different from that. This is an involuntary separation. Last year you were telling us it was not logical to pay unemployment benefits to someone whose 2-year enlistment expired because he could always reenlist and, therefore, his unemployment was a voluntary unemployment.

In this situation it is not voluntary. He is being mustered out of the service against his will. He would be perfectly happy to keep that job.

Mr. LEWIS. The closest analogy there, Mr. Pease, would be, in effect, dismissal for cause. Presumably there would be—the ones we are talking about would not meet the proficiency standards.

Mr. PEASE. I see. OK, I do not think we are going to get any place pursuing this.

Thank you very much, Mr. Secretary, and Mr. Chairman.

Chairman ROSTENKOWSKI. Thank you, Mr. Secretary. The committee will stand adjourned.

[Whereupon, at 3:35 p.m., the committee adjourned.]

[Material submitted for the record follows:]

U.S. GENERAL ACCOUNTING OFFICE,
Washington, D.C., April 13, 1982.

B-206899.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
House of Representatives.

DEAR MR. CHAIRMAN: At the request of your office, we are submitting testimony for the record regarding modified coinsurance and its use by some insurance companies to reduce their Federal income taxes. This testimony was also given to the Senate Committee on Finance. Our work was undertaken at the request of the Joint Committee on Taxation. It is an outgrowth of earlier work we did on the special provisions of the Internal Revenue Code under which life insurance companies are taxed.

By entering into modified coinsurance agreements under Section 820 of the Internal Revenue Code, some insurance companies—most notably the very large mutual companies—are able to convert investment income on which they pay taxes into underwriting gains on which they pay little, if any, taxes. This was not the intent of the Congress when section 820 was included in the code. It was intended to avoid possible double taxation when these coinsurance arrangements are used. Without a section 820 election, double taxation could occur because both the original insurer and the company sharing the risk would be subject to tax on some of the same income.

To study the section 820 problem, we used a sample of 42 large life insurance companies (24 mutuals and 18 stocks). In 1980 these companies held 73 percent of the industry's assets, about 60 percent of insurance in force, and collected about 54 percent of the industry's premiums. We are confident that our sample companies pay the bulk of the industry's Federal income taxes. Our findings to date indicate:

—For our sample companies, the amount of modified coinsurance reported jumped from about $7 billion in 1979 to about $147 billion in 1980. Of this increase, the ten largest mutual companies accounted for about $112 billion, or about 80 percent.

—Our sample companies reduced their tax burdens in 1980 from the prior year by about $625 million. However, when we break this down between mutual and stock companies we discover that the ten largest mutuals accounted for $558 million or 90 percent of this reduction.

—When we project the entire industry's tax burden, we estimate a 1980 revenue loss of approximately $1.5 billion, a drop of about 37 percent from what the companies would have paid had they not elected section 820. We also estimate a similar revenue loss of some $3.4 billion, or about 74 percent, in 1981.

Elimination of section 820 would no doubt eventually correct the current reduction of enormous amounts of Federal income taxes. However, we believe its elimination could reintroduce the problem of double taxation. Furthermore, we believe that the problem of section 820 should be viewed in the larger context of the Life Insurance Company Income Tax Act of 1959. In this regard, it is important that the problem of section 820 be considered in light of the substantially changed economic conditions in which the industry currently operates. Inflation and the high interest rates of recent years are dramatically different from those that existed in 1959. Because of these changed conditions, the 1959 Act has not operated in the manner originally envisioned.

Sincerely yours,

MORTON A. MYERS, *Director.*

Enclosure.

TABLE 1.—COMPARISON OF SAMPLE WITH INDUSTRY 1980

[Dollar amounts in billions]

	U.S. life companies	Sample	Percent of industry
Number of companies	1,948	42	2
Assets	$479.210	$349.843	73
Insurance in force	4,029.877	2,396.859	59
New insurance issued	596.738	320.220	54
Premiums	94.225	55.397	59

Sources: Life Insurance Fact Book 1981 and various Best's review statistical studies.

TABLE 2.—MODIFIED COINSURANCE REPORTED

[Dollar amounts in billions]

	1979	1980	Dollar change	Percent
Prudential		$12.860	$12.860	(1)
Metropolitan		39.657	39.657	(1)
10 largest mutuals	$1.289	112.871	111.582	8,656
24 sample mutuals	6.446	128.259	121.813	1,890
10 largest stocks		15.243	15.253	(1)
18 sample stocks	.348	18.527	18.179	5,224
42 sample companies	6.794	146.786	139.992	2,061

[1] Undefined.

Source: Annual statements, various years.

TABLE 3.—FEDERAL INCOME TAXES INCURRED

[Dollar amounts in billions]

	1979	1980	1979–80 change		1981	1980–81 change	
			Amount	Percent		Amount	Percent
Prudential	$0.380	$0.120	($0.260)	(68)	$0.032	(0.088)	(73)
Metropolitan	.343	.078	(.265)	(77)	.129	.051	65
10 largest mutuals	1.524	.966	(.558)	(37)	.615	(.351)	(36)
24 sample mutuals	1.837	1.247	(.590)	(32)	(1)	(1)	(1)
10 largest stocks	.535	.495	(.040)	(7)	.512	.017	3
18 sample stocks	.670	.635	(.035)	(5)	(1)	(1)	(1)
42 sample companies	2.507	1.882	(.625)	(25)	(1)	(1)	(1)

[1] Not available.

Source: Annual statements, various years.

ENCLOSURE

ENCLOSURE

FIGURE 2
FEDERAL INCOME TAXES INCURRED FOR THE TOP 10 MUTUALS (M) AND THE TOP 10 STOCKS (S)

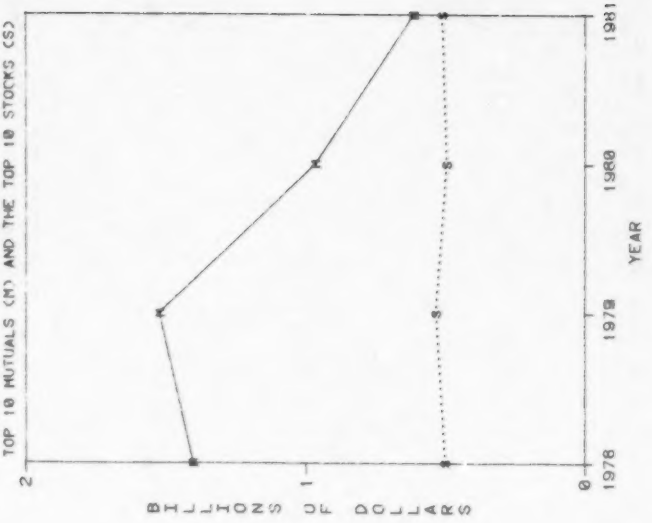
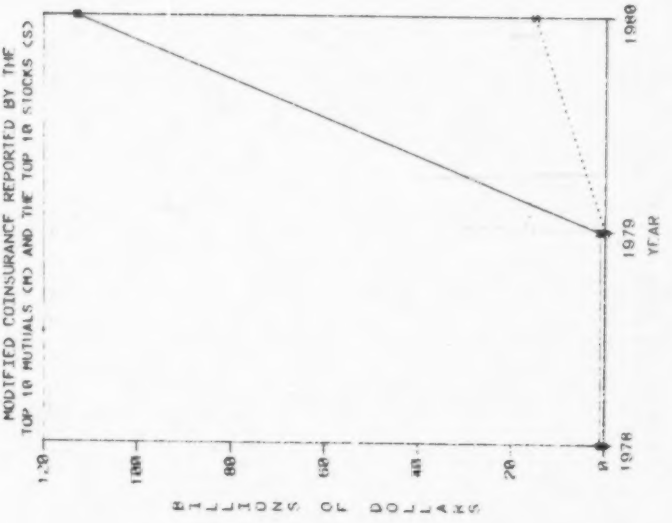


FIGURE 1
MODIFIED COINSURANCE REPORTED BY THE TOP 10 MUTUALS (M) AND THE TOP 10 STOCKS (S)



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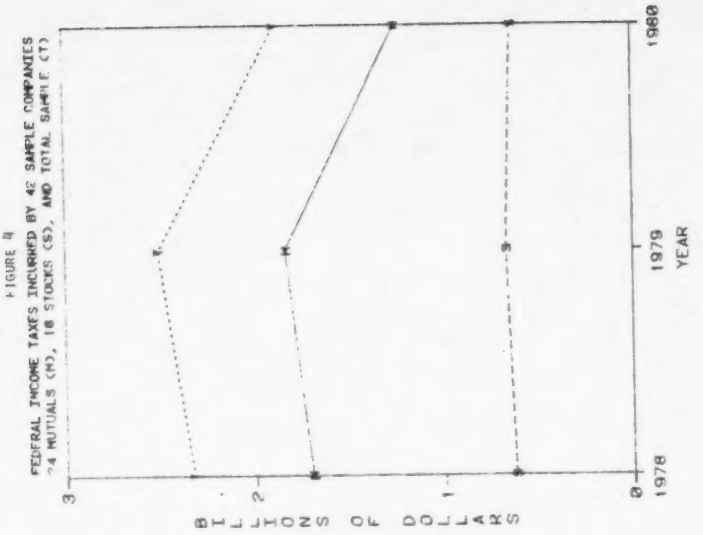

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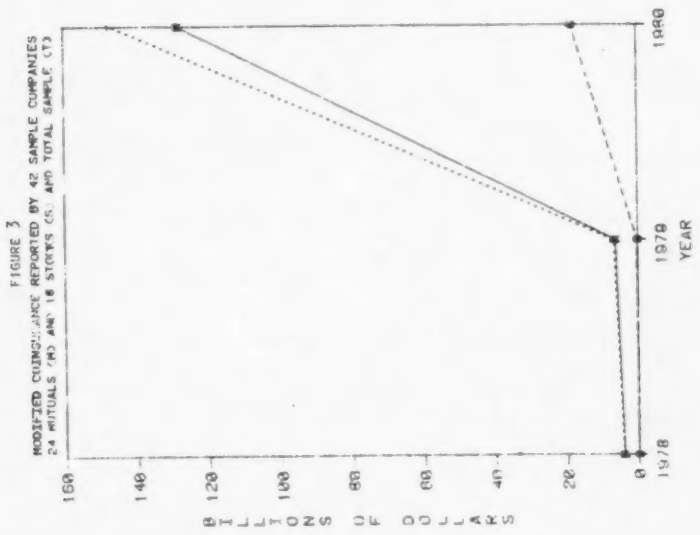

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Table 4

Estimated Revenue Losses
($ in billions)

	Estimated Taxes Assuming No Section 820	Estimated Taxes Incurred	Estimated Revenue Losses
1978	$2.994 a/	$2.994 a/	$ --
1979	3.479 b/	3.269 a/	0.210
1980	4.043 b/	2.551 a/	1.492
1981	4.699 b/	1.242 c/	3.457

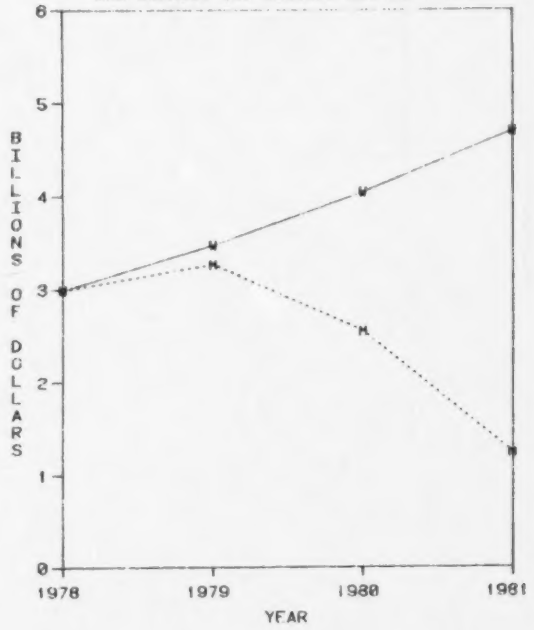
a/Life Insurance Fact Book, p. 64.

b/Projected at an annual growth rate of 16.21 percent, the geometric mean of the growth rates of the preceding 3 years. This compares to the ACLI/industry estimate of 15 percent annual growth rate.

c/GAO estimate based on a statement of Deputy Treasury Secretary R. T. McNamar, "In 1981 Treasury received only 38 cents for every dollar it received in 1979 from the life insurance industry..." "Daily Tax Report," (Bureau of National Affairs: Washington, DC, 1982), p. G-4.

Figure 5

Estimated Tax Incurred With (M) and Without (W) Section 820 Election



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STATEMENT OF HON. THOMAS A. DASCHLE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF SOUTH DAKOTA

Mr. Chairman and members of the Committee, I welcome the opportunity to testify on the Administration's most recent budget proposals and alternatives to those proposals.

According to the Congressional Budget Office, if the Administration's most recent budget propsosal is enacted without any change, deficits in four short years could total nearly $500 billion. Increasing the public debt by half a trillion dollars in less than half a decade will not produce substantial or sustainable economic growth and renewal. Economic policy bandwagonism is not the solution. The bandwagon is not on the road to economic recovery and the excess baggage being hauled by the bandwagon must be discarded.

The additional tax breaks for the oil industry contained in the Economic Recovery Tax Act are a prime example of the excess baggage being hauled by the economic policy bandwagon which must be discarded. These reductions in the windfall profits tax were the goodies and sweeteners included in the Administration's tax bill in order to attract the votes needed to achieve a political victory at any cost. The estimated cost of these additional tax breaks for the oil industry is $11.76 billion and the consequence is massive budget deficits. Last September, I introduced H.R. 4587 to repeal these additional tax breaks for the oil industry. Similar measures have also been introduced and collectively these measures have more than 140 cosponsors. The additional tax breaks for the oil industry incuded in the tax bill last year should be repealed.

The Economic Recovery Tax Act also contained the now infamous lease-a-tax-break, or safe harbor leasing, provision. According to recent reports, our nation's largest and most profitable corporations are benefiting handsomely from this loophole. The Standard Oil Company of Indiana, for example, has reduced its taxes by $159 million using the lease-a-tax-break provision. General Electric has been even more skillful. General Electric has reduced its federal income tax by $170 million compared to the previous year. General Electric, with pre-tax earnings of $2.66 billion last year, has reduced its 1981 federal income tax payment to an estimated $60 million, an effective tax rate of 2.25 percent, and will claim a tax refund of $150 million for prior years. In comparison, a South Dakota couple with $23,270 in taxable income last year filing a joint return will be paying $4,082 in federal taxes according to the IRS. This is an effective tax rate of 17.5 percent. The lease-a-tax-break loophole should be closed.

To reduce projected massive budget deficits, the Administration has proposed repeal of current incentives for domestic alcohol fuel production, including the 4¢ per gallon excise tax exemption for gasohol. The Treasury Department estimates repeal of current alcohol fuel production incentives would increase federal revenues by $100 million cumulatively during the next 5 years. Repeal of the alcohol fuel production incentives would reduce the projected 4-year, $500 billion deficit by less than 2/100 of 1 percent.

The current incentives for alcohol fuel production were enacted by Congress to encourage investment in a new domestic industry which would: produce high quality liquid fuel from renewable resources; reduce the nation's dependence on uncertain energy imports; increase energy competition; create new employment opportunities; provide new sources of federal revenue.

The private sector has responded to these incentives, including the 4¢ per gallon excise tax exemption which under current law will expire in 1992, and investment has begun in the production of alcohol fuel. Now, however, the Administration proposes a reversal of current policy.

On the subject of tax policy reversal, the opinions of Treasury Secretary Regan should be considered. Responding to proposals last year to amend the Economic Recovery Tax Act, Secretary Regan, said in part, "The stop-and-go policies of the past have undermined the Government's credibility, and such sudden about-face would convince individuals and business alike that the government is not to be counted upon, and that no commitment to save or invest was worth making in the current uncertain situation."

The proposed repeal of the current temporary incentives for alcohol fuel production is stop-and-go policy which undermines the credibility of the government and stifles investment. This stop-and-go policy should be rejected.

As justification for proposing repeal of the present temporary incentives for alcohol fuel production, the Treasury Department said, "In general, that incentives for

specific investments are inconsistent with the Administration's philosophy of relying on markets to allocate resources efficiently and with its policy to rely on the market, rather than Federal management, to determine patterns of energy use." There is an alternative to repeal of alcohol fuel production incentives which is consistent with the Administration's policy, would not cripple the infant alcohol fuel industry, and would substantially reduce budget deficits. This alternative includes repeal of the oil depletion allowance, the expensing of oil and gas intangible drilling costs, and other permanent tax breaks for the oil and gas industries which I proposed last year when I introduced H.R. 3525, the Tax Expenditure Reduction Act. Between January, 1979 and January, 1981, the 20 largest oil and gas companies accounted for 83.7 percent of the $19.6 billion in combined net income of the nation's 500 largest industrial corporations. Taxpayer subsidy of these giant profitable corporations should be eliminated and repeal of these special tax breaks for the oil and gas industry would increase federal revenue by $8.1 billion next year according to Administration estimates.

The new tax breaks for members of Congress should also be repealed. More than two centuries ago, "taxation without representation" was the rallying cry of the American Revolution. Today, two hundred years later, the issue is representation without taxation as the elected representatives of the American people can now avoid paying income taxes as a result of the recently approved tax breaks for Congressman and Senators. The U.S. House of Representatives should not become the House of Lords. I've introduced H.R. 5410 to repeal these tax breaks and they should be repealed.

To further reduce projected deficits, additional tax loopholes should also be closed. In 1968, tax loopholes reduced federal revenues by an estimated $44 billion. By 1975, the estimated cost of tax loopholes had increased 100 percent to $88 billion. Last year it was estimated tax loopholes currently reduce federal revenue by $266.3 billion and the cost of loopholes will continue to increase to $465.3 billion in Fiscal Year 1986.

Last year, I introduced House Resolution 262 requesting the Administration to propose a 12-percent reduction in the cost of tax loopholes. Recently, Alan Binder, a professor of economics at Princeton University has endorsed this approach by saying, "Paring tax expenditures seems to be both an efficient and equitable way to shrink the gaping budget deficits. For one thing, the beneficiaries of these tax expenditures are generally quite well off and have just been given sizable tax cuts. They have much stronger backs than the people who bore the brunt of the fiscal year 1982 budget cuts. For another, cutting tax expenditures would reduce some important tax distortions and promote economy efficiency; it is good 'supply-side economics'."

Professor Binder estimates a 12-percent reduction in tax expenditures would reduce the budget deficit by $35 billion and as Professor Binder has noted the President has declared the budget will not be balanced on the backs of the taxpayers or the Department of Defense and the backs of the poor alone may not be strong enough to balance the budget. Tax loopholes should be closed and the backs of the tax avoiders enlisted in the effort to reduce massive budget deficits.

In conclusion, as an original cosponsor of H.R. 5944, legislation recently introduced by Congressman Downey, a member of this Committee, I strongly support the speedy consideration of this measure. This vitally needed corrective legislation is deserving of prompt and favorable consideration by this Committee.

Statement of Hon. Marge Roukema, a Representative in Congress From the State of New Jersey

Mr. Chairman: Last December, in action that took a total of about eight seconds, the House of Representatives did more to undermine public confidence in this institution than they have for a long time. The Members were granted a $75 per day unitemized tax deduction for each day Congress is in session, and the limitation on outside earnings for Members was raised from 15 percent of annual salary to 30 percent.

These actions have been justifiably called "backdoor salary increases" because they occurred through parliamentary "sleight-of-hand" procedures instead of open, public recorded votes. Sponsors of these measures were correct in assuming that such action could never stand the light of a recorded vote; instead, the actions were taken without the knowledge or consent of most Members.

Specifically, the $75-per-day tax break was tacked onto a black lung benefits bill at the last minute by the Senate; a printed version was not made available to House

members before the vote on the bill, nor were we notified. The increased limit for outside earnings was done through a "unanimous consent" request before a nearly empty chamber. In short, there was no prior notification in either instance and no separate recorded vote. It is no wonder that the American people have expressed a sense of outrage; a recent editorial in a leading New Jersey newspaper captured that feeling well in an editorial called "Sleazy backdoor stuff." I have enclosed a copy of that editorial for the record.

Mr. Chairman, this Committee has a chance to remedy this situation and get rid of this unwanted tax break once and for all. Twenty-five Members have co-sponsored a bill I introduced, H.R. 5329, which would repeal the special tax break for Members of Congress. It would simply require Members of Congress to itemize on their tax returns, treating them as ordinary citizens who must account for their business expenses.

The support for my bill, which is pending before this Committee, is bipartisan. In addition, a number of similar bills were introduced by other Members in recent weeks; I think it is accurate to say that there is strong sentiment against this tax break in Congress. I would therefore urge you to bring H.R. 5329 out on the Floor and give the Members a chance to express their views.

I also want to take note of a Resolution I introduced, H. Res. 319, that would repeal the increase in the outside earnings limitation. It would return the permitted limitation to 15 percent of annual salary instead of the current 30 percent, bringing it back down to about $9,000 instead of the current $18,000. Although this Committee does not have jurisdiction over the Resolution, I do want to note that the earnings limitation increase is part and parcel of the public's loss of confidence in this institution. If Members feel they need a pay raise, they should be prepared to explain it to their constituents and vote on it publicly. They should not be granted special tax breaks and increased outside earnings, particularly if we note that the new outside earnings limitation unfortunately permits special interest groups to further subsidize Congressional salaries.

In closing, Mr. Chairman, I would again urge you to take note of the legitimate and justified public outcry on this issue. At a time when we are asking for budgetary and fiscal restraint, we should not at the same time be exempting Congress from its own responsibilities in this regard.

[From the Bergen (N.J.) Record, Mar. 30, 1982]

SLEAZY BACKDOOR STUFF

Members of Congress should be decently paid. Their responsibilities are heavy, their workloads grueling, and their tenure uncertain. But members have always been reluctant to raise their own pay—particularly members of the House, who have just two years between campaigns to live down such a vote.

Last year, this dilemma led Congress into an unseemly alternative. To make ends meet, members voted themselves large tax deductions, hidden away in general tax legislation. They allowed themselves a deduction of $75 a day for living expenses, whether or not Congress is in session and whether or not they're even in Washington—up to a total deduction of $19,000 a year. (The $19,000 limit is for those who don't itemize their deductions. Those who do can accumulate an even larger living-expense writeoff.) If you are in the 50 percent marginal tax bracket, a $19,000 deduction is worth $38,000.)

If members of Congress need a $38,000 raise to live in high-priced, housing-short Washington, let them make that case to their constituents. Even in the aggregate, such a raise would be a tiny fraction of overall government costs. Many taxpayers would be glad to pay the bill for pay raises if the decision were made in the open and appropriated directly to salaries. What makes voters angry is sleazy backdoor stuff like this deduction for "living expenses."

Common Cause, the government-reform lobbying group, is pressing hard for repeal of this little-known tax provision. To hasten repeal, Common Cause has proposed that lawmakers make public the sums they deduct as living expenses. Bravo to both those ideas.

ADVENTIST HEALTH SYSTEM—WEST,
Glendale, Calif., March 26, 1982.

Hon. DANIEL ROSTENKOWSKI,
Chairman, House Ways and Means Committee,
Washington, D.C.

DEAR MR. CHAIRMAN: On behalf of Adventist Health System—West, I request that this statement be included in the hearing record for the Committee's March 29 hearing on the Administration's revenue proposals.

I serve as President of Adventist Health System—West, a multi-hospital system based in Glendale, California. Adventist Health System—West is a non-profit, tax-exempt organization that has seventeen owned and managed hospitals in the states of California, Oregon, Washington, Idaho, Hawaii and Arizona with a total of 2,700 acute care beds and a gross revenue of approximately $400,000,000.

On February 26, 1982, the Treasury Department announced that the Reagan Administration would propose major restrictions on the current tax-exemption for bonds for tax-exempt organizations, including non-profit hospitals. Adventist Health System—West and each of its seventeen hospitals strongly oppose this proposal for the reasons outlined in this statement.

The Administration's proposal is based on the assertion that tax-exempt bonds issued for non-profit hospitals are utilized for "private activities." The proposal makes no distinctions among tax-exempt bonds for commercial and manufacturing enterprises, proprietary and non-profit hospitals, and non-profit education institutions. While the Administration's assertion may have some validity with respect to other users of tax-exempt financing, it is not accurate with respect to bonds of non-profit hospitals. The regulations of the Internal Revenue Service explicitly state that non-profit hospitals are entitled to tax-exempt status only if they serve a "public rather than a private interest." I.R.S. Regulations 1.501(c)(3)-(1)(d)(1)(ii). For the Treasury Department to characterize hospital bonds as bonds which I.R.S. relies in granting tax-exempt status to non-profit hospitals. As you can appreciate, non-profit hospitals must view this inconsistency potentially as having troubling and indeterminate long-term implications.

Contrary to the assertion of the Treasury Department, tax-exempt, non-profit hospitals serve a public purpose in the same sense as do public hospitals. As a matter of policy, as required in many states and as a condition for receipt of grants under the Hill-Burton program, non-profit hospitals provide free health care to indigents. Adventist Health System—West hospitals provided $2,916,386 in charity care and another $5,612,389 in bad debts written off. If the ability of non-profit hospitals to meet their capital requirements is impaired, public hospitals will be forced to increase their share of responsibility for providing medical care. For these reasons it is simply inaccurate for the Treasury Department to characterize non-profit hospital bonds as bonds for "private activities."

To justify its proposed restrictions on non-profit hospital bonds the Administration cites no abuse of the exemption. In the past there have been allegations that the existence of the exemption leads to construction of unneeded hospitals. This allegation, however, ignores the fact that in almost all cases non-profit hospitals must obtain a certificate-of-need before they may proceed with a construction project. No prudent investor would buy bonds for a hospital for which a certificate-of-need had not been obtained.

Nationally, when adjusted for inflation, hospital construction actually declined by 35 percent between 1971 and 1979.

Furthermore, this allegation fails to recognize that most tax-exempt financing is for renovation of existing facilities and refinancing of existing debt, not construction of new facilities.

Such renovation and refinancing may reduce hospital and patient costs. One of Adventist Health System—West's hospitals refinanced taxable debt to tax-exempt and realized savings in excess of $500,000 annually. Restricting the exemption therefore, is not needed to remedy any documented abuse.

The Treasury Department cannot claim that its proposed restrictions would result in much, if any, short-term increase in Federal revenue and reduction in the burgeoning deficit. In fact, for fiscal 1983 the Treasury Department acknowledges that its proposal will result in a net loss in revenue of $200 million. The Department has released no estimates on the revenue impact of that part of its proposal restricting the tax-exemption for non-profit hospital bonds but the fiscal 1982 Carter Administration budget estimated that the increased revenue in fiscal 1981 and 1982 from restricting the exemption would be only $35 million and $135 million, respectively. Fiscal year 1982 Budget, Special Analysis G at page 231.

These estimates do not take into account the automatic increases in Federal outlays under the Medicare and Medicaid programs due to increased claims for reimbursements fiscal year 1982 Budget at page 81. AHS-West currently has outstanding approximately $31,000,000 in long-term, tax-exempt debit. With a 48-percent rate of Medicare and 17-percent Medicaid utilization, this means that for every additional dollar AHS-West must pay in interest rates Federal government outlays for reimbursement to AHS-West will increase by approximately 65 cents. Assuming a three percentage point spread between the interest rates for tax-exempt and conventional financing, the added Federal reimbursement to AHS-West alone on existing debt would be approximately $2.28 million per year. This amount of increased Federal expenditures for AHS-West alone then is more than six percent of the Treasury Department's estimates for increased Federal revenue in fiscal 1981.

AHS-West has plans to seek approval within the next year for $78,000,000 of tax-exempt bonds. This financing will fund projects at five member hospitals of the AHS-West system, including the following projects: (1) remodeling of physical therapy. central supply and laboratory facilities; (2) relocation and expansion of acute psychiatric service (with an equivalent reduction in medical surgical beds); (3) remodeling of twelve medical surgical beds; and (4) renovation of current emergency medical, clinical lab, radiology, nuclear medicine, pharmacy, respiratory therapy, and nursery facilities. Were AHS-West forced to raise these funds through conventional financing, it will face an increase in interest payments of approximately $4 million per year and $120 million over the term of the bond. This additional payment is approximately 1 percent of the yearly gross revenues received by AHS-West and would necessitate raising patient costs by $7.00 per day over the thirty year term of the bond. Of this amount the Federal and State governments would reimburse AHS-West approximately $4.55 per patient per day and $78,000,000 over the term of the bond.

These estimates assume that conventional financing would be available to AHS-West to borrow $78 million. In order to obtain conventional financing, however, it is likely that AHS-West would be required by lenders to make a 20–40 percnt equity contribution to the financing of such objects. This contribution could only be generated by increased rates, charitable contributions, funded depreciation or other internal sources. For AHS-West a 30-percent equity contribution to these projects would be approximately $22,400,000, a staggering figure. If this contribution was generated solely by increasing rates for non-Medicare patients for one year, the increase would be approximately $85.00 per patient per day. Were the Federal government to reimburse the hospital for that portion of the equity contribution attributable to Medicare patients, the increase in rates for all patients would be nearly $40.00 per patient per day. This figure does not include the costs of the higher interest rates that AHS-WEST would have to pay to obtain such conventional financing.

In order for non-profit hospitals effectively to compete for conventional financing at market rates, they would need to be reimbursed for a reasonable return-on-equity. Without a return-on-equity non-profit hospitals would be forced to pay premium rates for conventional financing. If this return-on-equity was set at 18 percent, the rate currently available to proprietary hospitals, the additional Federal reimbursement to AHS-West would be approximately $18,000,000 per year.

The devastating financial impact from loss of the tax exemption for hospital bonds is exacerbated by the fact that current Medicare and Medicaid reimbursements fails adequately to compensate AHS-West for its costs. The shortfall currently is approximately 16 percent, meaning that ASH-West must attempt to shift this cost to its private pay patients. Given the fact that AHS-West has a higher than average Medicare and Medicaid patient load, its ability to shift these costs to other patients has reached the breaking point. For the Federal government now to restrict the tax exemption for the bonds that AHS-West must issue to renovate its existing facilities will place an intolerable financial burden on AHS-West.

On its face the Administration does not propose that the tax-exemption for non-profit hospitals be completely eliminated. Depending on how the proposal is interpreted, however, it could well have this effect. For example, the Administration proposes that tax-exempt bonds be available only where the governmental unit make a "financial contribution or commitment to the project" in an amount equal to one percent of the face amount of the bond. General and Technical Explanation at page 28. This contribution must be "specifically earmarked for the facility or project," meaning that "(g)eneral tax reductions or regular services provided to all facilities are not counted for this purpose." Id. at 28–29. Were this requirement applied to non-profit hospital bonds, such bonds would not be available. The Constitution in most states would prohibit such a contribution and in other states facing mamouth Federal aid cutbacks, no funds would be available to make such a contribution.

The Administration proposal does state that "general tax exemptions provided from exempt organizations under State law could be used to satisfy the contribution requirement with respect to projects for exempt organizations." Id. The meaning of this qualification is ambiguous. If it means that State and local governments would not be required to make a financial contribution specifically earmarked to a project of a non-profit hospital, it would mitigate the impact of the financial contribution requirement. Adoption of such a qualification is warranted for tax-exempt organizations because State and local government already make an indirect financial contribution to such organizations by granting them an exemption from State and local taxes. To require that such governmental units make an additional contribution to each specific project is inequitable and unreasonable. Given the tax-exempt status of non-profit hospitals, a State or local government cannot further abate the State or local taxes of the hospital. This means that any additional financial contribution to a specific project would likely have to take the form of a direct equity contribution to the project, the form of contribution that specifically is prohibited in many State Constitutions.

The key issue facing hospitals in the 1980's is capital formation. Hospitals are consuming their own capital largely due to current Federal reimbursement policies that do not cover full costs of operation and ignore the requirement to reimburse non-profit hospitals for a return on equity. The result, over time, is that hospitals increasingly are assuming greater levels of debt to replace existing assets. As this statement demonstrates restricting the tax exemption for non-profit hospital bonds would severely exacerbate the financial strain already felt by non-profit hospitals, impair their ability to renovate and modernize existing facilities, and prevent expansion in those areas mere patient needs warrant construction of additional facilities.

On behalf of Adventist Health System-West, I appreciate your consideration of these issues.

Very cordially yours,

FRANK F. DUPPER,
President, Adventist Health System—West.

STATEMENT OF THE AIR TRANSPORT ASSOCIATION OF AMERICA

Mr. Chairman and Members of the Committee: This statement is being submitted by the Air Transport Association of America (ATA) on behalf of its member airlines to emphasize the crucial economic importance of the leasing provision of the Economic Recovery Tax Act (ERTA) of 1981, specifically Section 168(f)(8) of the Internal Revenue Code.

The airlines currently have on order or option through 1985 some 400 aircraft worth a total value of $15 billion—and involving scores of thousands of jobs—which could be affected by a decision to repeal the leasing provision. These are two notable examples. Eastern Airlines has stated that retention of leasing is absolutely essential if it is to proceed with any assurance of consummating its planned purchase of $1 billion of new fuel efficient and quieter aircraft over the next two to three years. On March 26 United Airlines reported that it had notified the Boeing Airplane Company "to stop work on twenty new generation aircraft worth nearly $1 billion pending resolution of Congressional proposals to modify safe harbor leasing provisions of the ERTA of 1981".

The airlines consider the improved and equitable means of capital formation and investment to be the most significant aspect of the ERTA of 1981. The leasing provision is the means by which equitability is achieved, and it is fundamentally important for improving productivity and creating jobs. The airlines, currently distressed by record losses, urge its retention. It represents a long overdue step in tax reform.

The airline industry, hit by two recessions, fuel costs, the illegal action of the controllers, and high interest rates, has experienced massive operating losses in the last two years. For the 12 months ending in June 1982, it could sustain a staggering operating loss of $1 billion. As shown below, since 1979, operating revenues have continued to increase, but operating expenses have grown more rapidly, producing large operating losses in 1980 and 1981 and net losses in 1981.

U.S. SCHEDULED AIRLINES—RESULTS OF OPERATIONS

[In millions of dollars]

	1979	1980	1981 [1]
Operating revenues	27,227	33,659	36,300
Operating expenses	27,028	33,884	36,700
Operating profit (loss)	199	(225)	(400)
Net profit (loss)	347	19	(200)

[1] Preliminary.

The airlines are one of the nation's most capital intensive industries. They have a high debt to equity ratio and find it extremely difficult to obtain substantial equity or debt financing. Yet, there is a continuing need to upgrade equipment in order to increase productivity and offset the high costs of fuel, labor, and other expenses.

The airline industry has on order or option billions of dollars in new aircraft and associated spare parts. These orders, placed a number of years ago, include current production aircraft (DC-9-80, DC-10, L-1011, B-727-200, B-737-200 and B-747) and new production aircraft with the latest technology available (B-737-300, B757 and B-767). The B-757 and B-767 aircraft are currently undergoing flight certification testing and the first deliveries will take place late in 1982 and early 1983.

New orders create thousands of jobs in the aerospace industry throughout this country. The new aircraft are needed by the airlines to continue to provide the best air transportation system in the world at the lowest possible price and to achieve increased productivity, lower noise levels and higher fuel efficiencies. Without the Special Rule for Leases—the so-called safe harbor lease provision—many of these aircraft orders will be cancelled or delayed because the airlines will be unable to obtain financing at reasonable costs or utilize the investment incentives of the Accelerated Cost Recovery System (ACRS) and the Investment Tax Credit.

Prior to the enactment of ERTA of 1981, the airline industry had advocated improvement in the Investment Tax Credit. We pointed out that for capital intensive industries such as the airlines, autos, steel, railroads, paper, mining and cement, the investment tax credit was an incentive that all too often was not realizable because of the lack of sufficient earnings. At the end of 1980, the airline industry had accumulated $650 million of earned, but unused, investment tax credits.

During last year's hearings on the Economic Recovery Tax Act, ATA emphasized that the Accelerated Cost Recovery System would be of little use in the volatile earnings cycle of the airlines and other industries where accelerated depreciation often increases taxable losses. Still, ATA endorsed the ACRS but expressed the hope that a mechanism would be provided that would make its benefits and the benefits of the investment tax credit available to all business enterprises including the marginally profitable companies, the newly developing companies, and capital intensive companies that experience wide cyclical variations in profitability such as the airlines.

The safe harbor lease provision of ERTA is the mechanism that Congress provided to assure that the tax benefits would be available to all companies. As a result, airlines and companies in other industries acquiring property in 1981 were able to transfer the tax attributes to another corporation and receive in cash nearly the full equivalent of the tax incentives intended by Congress. In the past, airlines employed the so-called leveraged lease to transfer the tax attributes of a property to a leasing institution, but this was a less efficient method than the safe harbor lease. Under the safe harbor lease, the airlines receive nearly all of the value of the tax incentives. Thus, investment in new equipment is both encouraged and made possible.

Much of what has been said and written about safe harbor leasing has led to serious misunderstandings of its main purpose. First, some have said that safe harbor leasing is a subsidy to prop up inefficient and failing companies. The fact is that safe harbor leasing provides a means for all companies to receive the benefit provided by law for investments. Rather than a subsidy, it establishes equity for all investors. Secondly, safe harbor leasing has been mistakenly called a "gimmick" that creates unwarranted tax deductions. In reality, safe harbor leasing makes available to investing companies without taxable income the benefits of the deductions and credits provided in the Internal Revenue Code in the same manner as they are available to other companies, thus assuring neutrality and equity.

It has also been said that the purchaser/lessor of tax benefits realizes a greater benefit than the seller/lessee. This is not correct. The negotiations of a safe harbor lease are conducted by knowledgeable people with a full understanding of the cost

and benefits of the transaction. At the conclusion of the agreement, both parties will have received equal value with significantly reduced transaction costs.

Another contention is that a refundable Investment Tax Credit is more efficient, less costly and a preferable alternative to safe harbor leasing. It must be noted, however, that a refundable Investment Tax Credit, in the opinion of many experts, would increase enforcement and compliance problems for the IRS in order to assure that qualified investments are made in accordance with the Internal Revenue Code. In a safe harbor lease, the lessor corporation guarantees that an investment is made. Additionally, a safe harbor lease includes the value of ACRS deductions, which are not reflected in a refundable investment tax credit.

In summary, the airline industry strongly supports the retention of the safe harbor lease provisions enacted in 1981 because it is vital to fleet modernization, improved productivity and the creation of jobs throughout the nation.

ADMINISTRATION TAX PROPOSALS

The Administration has included in its proposed budget for 1983 a number of changes in the current tax law which are of concern to the airlines; specifically, the proposed increase in aviation user taxes, the proposed additional requirements for tax exempt airport development bonds, and the alternative corporate minimum tax.

Aviation user taxes

The Administration has proposed, in connection with its national airways system plan, reestablishing the taxes on airline passengers and shippers at the prior levels (8 percent passenger tax, 5 percent cargo tax, and $3.000 international facilities tax) and taxes on fuel consumed by non-commercial aviation.

The Air Transport Association and its member airlines have and will continue to support tax levels sufficient to fund the Airport and Airways Trust Fund and its authorized programs. However, we believe that it is inappropriate to place a tax on aviation users at a level that will result in substantial surplus in the Trust Fund, as has been the case in the past.

The Committee on Public Works and Transportation is currently holding hearings on the Administration's plans for modernization of the airways system and will no doubt be recommending Trust Fund expenditures in this connection. We urge that this Committee not establish the aviation user taxes until the Committee on Public Works and Transportation has submitted its recommendations. In this way, the tax levels can be established to fund the authorized programs.

Tax exempt airport bonds

The proposed changes in the qualification for tax exempt airport development bonds will have a significant impact on future airport development in this country. Under current law, interest paid on bonds issued by a government agency to finance the construction or development of an airport is exempt from taxation. The Administration has proposed additional qualification criteria for tax-exempt bonds which include, among other things, the requirement that the government agency have a financial participation in the project funding without being able to recover its costs through subsequent user charges. Since the only income that most airport authorities receive from fees and other charges levied on users of the airport, this requirement would for all practical purposes preclude the issuance of tax exempt airport development bonds.

The Treasury in its General and Technical Explanations of Tax Revison and Improved Collection and Enforcement Proposals justifies the new qualifications, including financial participation, on the fact that there has been a rapid growth during the past five years in the volume of industrial development bonds and certain other tax exempt bonds which benefit non-profit hospitals and non-profit educational institutions.

Although Treasury noted that the largest growth has been in small issue IDB's, it did not indicate that there has been any substantial or unusual growth in tax exempt airport bonds. Treasury concludes that the expansion of industrial development bonds adversely affects the market for tax exempt securities as a whole, raising the cost to state and local governements of financing traditional public services.

A public airport is, by any standard, a traditional public service and there is a very long history of financing airport improvements through the issuance of tax exempt airport development bonds. For example, San Francisco issued its first airport bonds in 1927; Los Angeles issued its first airport bonds in 1941; and Atlanta issued its first airport bonds in 1946.

Airports, and their development, have always been deemed to be a traditional and genuine public project and the bonds issued to finance them are necessarily imbued

with a "genuine public purpose". In *People ex. rel. Curran* v. *Wood*, 391 Ill. 237, 62 N.E.2d 809 (1945), the Illinois Supreme Court observed "[s]o far as the public interest and the public safety are concerned there is no essential difference between the operation of a public airport and that of a highway, subway, wharf, public park, and the like".

Since airport bonds are traditional tax-exempt obligations that are issued in the furtherance of a genuine public purpose, such bonds should not be subject to the proposed additional requirements contained in the Administration's tax proposals.

Alternative corporate minimum tax

This proposed tax will have a significant adverse impact on the airlines even though there is very limited use of the enumerated tax preferences. The airline industry, because of its current losses, will generate significant net operating loss carryovers which, under current law, can be carried forward and used to offset income in future years and thus reduce the cash flow impact of taxes during recovery periods. These companies, as we have pointed out, also have a significant accumulation of earned, but unused, investment tax credits which under current law can be used to offset 90 percent of taxes otherwise due. The Administration has proposed a 15 percent minimum tax on taxable income before application of NOL's and that minimum tax would not be reduced by Investment Tax Credits. Thus, in a period when the airline industry needs to make major investments in new aircraft and expects to be recovering from the current earnings slump, it will be faced with a significant tax even though there will be unused NOL and investment tax credit carryovers.

The ATA and its members appreciate the opportunity to provide comments on these important issues and hope that the members of the Committee find the comments useful.

AMERICAN ASSOCIATION OF STATE HIGHWAY
AND TRANSPORTATION OFFICIALS,
Washington, D.C., April 8, 1982.

Hon. DAN ROSTENKOWSKI,
Chairman, House Ways and Means Committee, U.S. House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: We are aware that the Ways and Means Committee has been taking testimony on possible revenue measures to be considered by Congress responding to our national budget problems. This letter is related to those hearings, and we respectfully ask that it be made a part of the record and taken into account in your deliberations.

There are two revenue measures now under general discussion in Washington that have our particular interest, and we would like to offer observations on both. The first is the equivalent 5 cents per gallon raise in highway user fees which has been advanced by Secretary Drew Lewis of the Department of Transportation, and the second is the proposed $5 per barrel tax on imported petroleum.

Turning first to the Lewis proposal, it has been courageously advanced in this time of budgetary crisis by the Secretary because he believes the immediate needs of our nation's highways and mass transportation systems demand attention now. Speaking on behalf of the public officials responsible for the construction, maintenance and operation of highway and transportation systems in the states, Puerto Rico and the District of Columbia, we share the Secretary's opinion that the need for significantly increased revenues now is critical.

In our professional judgement, the needs of the Federal-aid portion of our nation's highway system requires increased revenues equivalent to an effective doubling of the present 4 cents per gallon motor fuel tax, which has not been adjusted since 1959. The Federal Highway Administration and other experts on the condition of our nation's highway system share our judgement of this need. Currently, some 10 percent of the Interstate system is badly in need of restoration, and this need increases each year. We nationally face a bridge restoration need of over $50 billion, and our primary, secondary, and urban highways must receive greater attention to remain serviceable. Citizens and business enterprises are now paying the costs for the poor condition of a growing portion of our highway system, and bad roads are an expanding factor leading to a decline in national productivity.

We would note that many state legislatures have been moving to enact measures to increase revenues available for the state share of our highway needs, and other legislatures are even now considering the matter. Our recent AASHTO survey of member departments indicates that the states are prepared to match a Federal-aid Highway program in the $12 to $14 billion range, a program level that would come

close to meeting the need. Secretary Lewis' 5 cents proposal, with 4 cents earmarked for the Federal-aid Highway program, would enable a program of this size.

A feature of Secretary Lewis' program is the use of revenues from 1 cent of his proposed increase for mass transportation, which will help meet the needs of our mass transportation system. If those needs are not addressed, the economic problems of both the public and private sectors of many cities and rural areas will increase, and our national transportation system will suffer.

We recognize that Secretary Lewis' proposal is not now formally before you. Nevertheless, we ask that you take it into account, when making decisions on revenue measures.

Addressing now the oil import tax, we have a number of concerns that we hope will be taken into account as you discuss the measure. We note that such a tax will have an across-the-board impact on the American economy, because petroleum is utilized for motor fuel, heating and power generation purposes, in the plastics industry, and elsewhere. Given this broad impact, the oil import tax could thus cause a significant increase in the general inflation rate. Further, to the extent such a tax functions as a disincentive to motor fuel usage, it will act to reduce highway user fee collections from fuel taxes at the same time that the inflation impact of the import tax is increasing construction costs. To this extent, it will make the existing highway needs situation worse, unless provisions are also made to substantially increase Highway Trust Fund revenues.

In contrast to the oil import tax, the impact of Secretary Lewis' 5 cents proposal would be largely confined to those who purchase motor fuel, the users of our nation's highways. It would thus not act adversely across the entire economy in the manner of the oil import tax. Further, if the revenue from this proposal is fully utilized in the Federal-aid program it woud result in a direct positive impact on the American economy, by providing increased funds to purchase materials and labor, and by helping to arrest further deterioration in our transportation system with a consequent positive impact on productivity. Finally, the Secretary's proposal would also offer a two year, $8 billion positive impact toward the Federal deficit situation, because of the inherent lag between authorizations and outlays in the Federal-aid Highway program.

We hope these views will be of use to you, in making decisions on these and other tax measures. If there is any way in which we can be of assistance to the Committee, please do not hesitate to let us know.

Very truly yours,

FRANCIS B. FRANCOIS,
Executive Director.

STATEMENT OF DR. CHARLS E. WALKER, CHAIRMAN, AMERICAN COUNCIL FOR CAPITAL FORMATION

SUMMARY

1. The American Council for Capital Formation applauds this Committee's intent to review the revenue increase proposals in the Administration's fiscal year 1983 budget and other revenue raising initiatives in order to fashion bipartisan consensus on a productive approach to the current economic situation.

2. The ACCF urges caution in evaluating alternative proposals to reduce spending and raise revenue. Great care must be taken to enact measures that do not work against the carefully structured economic recovery program the Administration proposed and the Congress, in a praiseworthy bipartisan effort, enacted last year.

3. The decade of the 1970's proved to be one of testing for the economic theories that had dominated policymaking for the past fifty years. Federal taxes and spending rose precipitously as a share of GNP; economic growth stagnated; and inflation soared. The Revenue Act of 1978 marked a major turning point in economic policy in general and tax policy in particular, signalling a turning away from Keynesian policies affecting demand toward tax policy as a supply-side tool.

4. It is far too early to judge the success of the program of budget restraint and tax incentives put in place last year. While substantial progress has been made in dealing with Public Enemy No. 1—inflation—interest rates remain stubbornly high, threatening the timing and strength of the recovery.

5. Action is needed now to hold Federal spending for on- and off-budget items, at a minimum, to the three-quarters of a trillion dollar level the Reagan Administration has proposed for FY 1983. As its major contribution to the adjustment in the economic game plan, Congress should act to ensure that spending levels do not rise

above the level requested by the President. For his part, the President should agree to steps that would significantly reduce deficits in 1983 and beyond.

6. The ACCF prefers the spending cut route over the tax increase approach to deficit reduction. If tax increases are necessary, Congress should be careful not to undo the critically important capital formation initiatives enacted as a part of the Economic Recovery Tax Act of 1981 (ERTA).

7. The ACCF strongly opposes the new corporate minimum income tax proposed by the Administration. This measure would undercut the capital formation aspects of ERTA and shake business confidence in the staying power of those incentives as well as some enacted in prior years. Business needs to know it can count on the laws on the books in order to plan for the future with confidence. We are also concerned that the proposed new corporate minimum tax will blunt the incentive effect of the investment credit and impose a penalty tax where no economic gain exists.

8. For the longer run, the ACCF urges this Committee to support enactment of S.J. Res. 58, the Tax Limitation-Balanced Budget Constitutional Amendment that would mandate in advance of each fiscal year that Congress adopt a budget statment under which outlays would be limited to the rate of growth in national income in the preceding calendar year. The timing proposed in this Amendment would fit nicely with Congressional intent to restore a balanced Federal budget by fiscal 1985 or 1986 since, under the proposed timetable, the Amendment would become effective in fiscal year 1986.

STATEMENT

Mr. Chairman and Members of this distinguished Committee: My name is Charls E. Walker. I am volunteer Chairman of the American Council for Capital Formation. I am grateful for this opportunity to present the views of the American Council on the revenue initiatives proposed by the Administration and others—in particular, proposals for a new minimum tax on corporations.

The American Council for Capital Formation is an association of individuals, businesses, and associations united in their support of legislation to eliminate the tax bias against saving and productive investment. Our members, individuals as well as business, support legislative measures which are designed to encourage the productive capital formation needed to sustain economic growth, reduce inflation, restore productivity gains, and create jobs for an expanding American work force.

We applaud the Ways and Means Committee's intent to review in a timely manner the revenue increase proposals included in the Administration's fiscal year 1983 budget and other revenue raising proposals in order to fashion a bipartisan consensus on a productive approach to the current economic situation. We urge you to evaluate with utmost care the alternative proposals put forth by the Administration and Members of Congress to reduce spending and raise revenue. While reduction in the large forecasted Federal deficits over the next few years should be a priority of this Congress, great care must be taken to enact measures that do not work against the carefully structured economic recovery program the Administration proposed and Congress, in a praiseworthy bipartisan manner, enacted last year.

With the enactment of the Economic Recovery Tax Act of 1981 (ERTA) we have in place tax incentives that, over time, will lead to strong economic growth and increases in living standards for all Americans. Let us not act in haste and damage, perhaps irrevocably, the promise of the future.

Today, I would like to review the emergence of the consensus on an economic policy for the 1980's. Because the country now faces record-breaking deficits, I would also like to suggest needed short-run adjustments to the economic "game plan" put in place last year.

ECONOMIC POLICY FOR THE 1980'S

The development of a consensus

The decade of the 1970's proved to be a time of testing for the economic theories that had dominated policymaking for the past fifty years. In recent years, the economy has been in a long-term decline characterized by "stagflation"—inflation at double digit levels in an economy plagued by stop and go performance, sluggish real growth, and too-high levels of unemployment. The rate of growth in real GNP—which is the most basic measurement of the performance of an economy—had fallen from a rate of 4.3 percent per year from 1959 to 1965, to 4 percent fro 1965 to 1969, to 3.6 percent from 1969 to 1973 and to 2.8 percent from 1973 to 1979. Productivity growth, which directly affects the standard of living a society enjoys, had declined sharply over the period.

In addition, the Federal sector had grown rapidly over the decade and was absorbing a high and evergrowing proportion of our nation's economic resources. Total Federal outlays, for example, advanced by 455 percent and nominal GNP by 333 percent from 1965 to 1981. This resulted in a pronounced long-term rise in the ratio of total Federal outlays to GNP. In particular, total Federal outlays rose from 18 percent of GNP in 1965 to 23 percent in 1981. Only twice during the 1970's did Federal spending as a share of GNP fall below 20 percent. On the basis of Administration assumptions and budgeted spending levels, that ratio is now expected to top out at 23.5 percent in the current fiscal year and decline thereafter.

It is clear that the spending programs initiated in the mid-1960's enlarged the share of the nation's resources allocated by the Federal government. Additionally, a shift has occurred in Federal spending priorities over this period, especially from defense to nondefense spending. In 1965, nondefense spending measured 60 percent of budget outlays; by 1981, the nondefense share had risen to nearly 76 percent.

The rapid growth in Federal spending fostered inflation in at least two ways. First, with a firmer monetary policy and even higher interest rates it would have been possible to finance these deficits in a noninflationary manner; that is, by borrowing genuine savings. But, the fact is that too large a portion of the deficit was indirectly monetized by Federal Reserve purchases of government securities in the open market. Monetary growth was excessive and the price level shot up. Second, the transfer payments that made up a substantial portion of the increase in outlays represented a shift in resources from the more productive to the less productive sectors of society. Therefore, capital formation was slower than it would otherwise have been.

As Federal spending rose, taxes went up also, but not by enough to assure balanced budgets. At 21 percent of GNP in fiscal year 1981, Federal tax receipts were at the highest ratio since World War II. This heavy tax burden contributed to inflation through its impact on incentives to work, save and invest, and the resulting negative impact on productivity.

The heavy tax burden was especially inimical to solid economic growth because of its distribution. Reflecting outmoded economic theories that emerged during the Great Depression, the existing tax system as we entered in the 1980's was biased heavily in favor of consumption and against productive saving and investment. For individuals, the high marginal rates that seemed justified to some people in earlier times as good social policy sharply impinged on incentives for individuals to work, save and invest. They also generated the "bracket creep" that seems so unfair to the middle-income Americans who pay the lion's share of individual income taxes. High business taxes depressed capital formation and productivity by reducing the rate of return on new investment and cutting the cash flow available to finance that investment.

Congressional action

In 1975, the Ways and Means Committee began hearings on what would become the Tax Reform Act of 1976. Tax reform pressures of the traditional "loophole closing" variety crested with that Act, as the public and Congress became increasingly convinced that the developing capital formation problem was not only significant but also could be critical to the nation's long-run well-being. I might add that the work of the Task Force on Capital Formation of this Committee, which met weekly between February and September of 1976, paved the way for what was to happen next.

The Revenue Act of 1978, shaped in crucial ways by this Committee, marked a major shift in economic policy n general and tax policy in particular. At last we began to turn from naive Keynsian policies affecting demand to see fiscal policy as a supply-side tool. The 1978 Act sharply cut the maximum tax on capital gains for individuals, strengthened the investment tax credit, and reduced corporate tax rates, leading the way for the profound changes that would occur over the next few years in tax and economic policymaking. By 1980, it was clear that it was time to change—time to take a hard look at the costs as well as the benefits of government regulations; time to bring Federal spending under control; time to change the tax code to spur saving, personal effort, and risk taking; and time to conduct monetary policy to curb inflation and keep it in check.

In its second consecutive unified annual report, issued in 1980, the Joint Economic Committee signalled the coming of age of this new era in ecomomic thinking. That report recommended that "fully one-half of the next tax cut be directed to enhancing saving and investment in the economy." Noting that traditionally tax cuts had been designed solely as countercycle devices, the JEC went on record in support of the position that tax cuts can and should be directed toward improving productiv-

ity performance over the long-run. In addition, the JEC recommended that the ratio of government spending to GNP be reduced.

The Reagan administration's game plan

Coming into office in 1981, the Reagan Administration quickly moved to put in place the supply-side concepts that had been moving into the mainstream of economic thinking. The Administration's 1981 program of budget restraint, approved by Congress, sharply reduced the rate of growth of Federal spending in fiscal year 1982; and further cuts have been proposed in that growth rate in fiscal year 1983 and beyond. The Economic Recovery Tax Act of 1981 reversed the upward trend in taxes relative to GNP and also strengthened incentives to work, save and invest. These steps, along with a retreat from the overregulation of business activity and strong moral support for a Federal Reserve policy of more stable monetary growth, constituted what the press has called "Reaganomics."

The current economic climate

It is far too early to judge the success of this program. Progress in dealing with Public Enemy No. 1—inflation—has exceeded expectations and, indeed, is the most significant single development of the past year. But, with inflationary expectations deeply imbedded, the return to a non-inflationary environment was bound to take time and involve hardship. That hardship arrived in 1981 in the form of recession, with output dropping sharply and unemployment approaching 9 percent. Interest rates, which Administration policymakers expected to fall as inflation receded, remained stubbornly high, threatening the timing and strength of recovery from the recession.

"Real" interest rates—i.e., market rates less the expected rate of inflation—are at very high levels. According to one school of thought, these high rates—particularly for long-term securities—reflect market fears that, despite the protestations to the contrary, Federal Reserve authorities will sooner or later cave in to political pressure and unduly inflate the money supply to help fight recession and unemployment. Financial market skittishness in this respect is demonstrated by experience over the past two years—each time the rate of monetary expansion has moved above Federal Reserve target ranges, interest rates have tended to go up, but when monetary growth has stayed within bounds, interest rates have come down.

Administration policymakers argue that lower inflation rates must ultimately result in lower interest rates because the inflationary premium which became incorporated into rates in the 1970's will sooner or later be wrung out. They also maintain that the personal saving rate, which has averaged only 5.4 percent of disposable income over the past few years, will rise to at least the 8 to 8½ percent range that prevailed during most of the first half of the 1970's. Following the Kennedy-Johnson tax reductions in the first half of the 1960's—on balance, a very good supply-side tax cut—the personal saving rate rose sharply. The Reagan tax cuts on individuals are concentrated on people who do the most savings, and the new Individual Retirement Accounts constitute a major pro-saving force. With each percentage point representing $20 billion in saving, the potential contribution of an increase in the personal saving rate to noninflationary financing of Federal deficits is obvious.

SHORT-RUN ADJUSTMENT TO THE GAME PLAN

The deficit question

Now, however, many voices have been raised to complain that the Federal deficits projected over the next few years are simply too large. It is widely believed, particularly in financial markets, that it is these deficits that are keeping interest rates high and threatening economic recovery. Such deficits, say the critics, will collide with anti-inflationary monetary policies and the only possible result will be high interest rates and "crowding out" of private investment. Moreover, financial markets quite clearly believe that the deficits now in prospect spell trouble, thus impeding the decline in interest rates justified by the improved outlook for inflation.

Deficit financing as a way of life is bad public policy. It removes a practical limit on growth of the Federal sector—growth that got us into this mess in the first place. Chronic deficits also rob financial markets of funds that could otherwise be used to support the capital formation this country so badly needs.

An adjustment to the economic game plan that will sharply cut near-term deficits and return us to a balanced budget relatively soon is, therefore, urgently needed. This correction need not at all disturb the basic framework of Reaganomics that the Administration and Congress put in place last year. It is an adjustment that should be negotiated between the Congress and the Administration, in a spirit of compromise, on a bipartisan basis.

Guidelines for a compromise

The Administration, in its fiscal year 1983 budget, has proposed a series of tax and spending changes that it estimates will hold the deficit to somewhat above $90 billion in 1983, $80 billion in 1984, and slightly above $70 billion in 1985. However, without corrective action of any kind, the Federal deficit in fiscal year 1983 could well rise to triple-digit levels and remain there for several years to come. Deficits of this magnitude, well in excess of peacetime experience, would impose extreme pressures on financial markets, undermine the outlook for continued monetary restraint, reduced inflation, and economic growth.

Clearly, action is needed to hold spending for on- and off-budget items, at a minimum, to the three-quarters of a trillion dollar level the Administration has proposed for fiscal year 1983. As its major contribution to the adjustment in the economic game plan, Congress should act to ensure that total spending levels to not rise above the level requested by the President, or 22.5 percent of the Administration's GNP forecast. For his part, the President should agree to steps that would significantly reduce deficits in 1983 and beyond.

The ACCF strongly favors the spending cut route over the tax increase approach to deficit reduction. The Administration has put before the Congress a number of proposals to reduce spending; Members of Congress have likewise suggested responsible spending cut initiatives. If there are to be tax increases, the Congress should be careful not to undo the critically important capital formation initiatives enacted as a part of the Economic Recovery Tax Act of 1981.

The revenue side

The Administration has proposed a number of revenue raising options in its fiscal year 1983 budget. Unfortunately, some of these measures, while perhaps attractive from a revenue standpoint, would actually work against economic recovery and impose an undue burden on the business firms least able to withstand further deterioration in cash flow. According to a Congressional budget office analysis, a little more than 20 percent of the Administration's deficit reduction proposals for the 1983–1985 period involve revenue increases. However, nearly 75 percent of the revenue increases would come in corporate taxes, offsetting about 60 percent of the corporate tax reduction enacted in ERTA for that period.

The ACCF specifically urges you to oppose substantive modifications to the recently enacted Accelerated Cost Recovery System (ACRS). The need for a complete and thorough overhaul of our outmoded capital cost recovery system was clearly recognized by the Congress through the enactment of the ACRS provisions of ERTA. The new system will encourage the injection of new investment funds for modernized plant and equipment which are essential to the economic progress and well-being of all Americans.

The largest single revenue raising option proposed by the Administration is a new corporate minimum income tax. The Administration would repeal the current 15 percent corporate add-on minimum tax and replace it with a 15 percent alternative minimum tax. Under the proposal, corporations would pay the alternative minimum tax only when it exceeds the regular income tax. In general, the tax base for the alternative minimum tax would be a corporation's regular taxable income increased by certain tax preferences for the year. Net operating losses would not be allowed in computing the minimum tax base. The tax base would be reduced by a $50,000 exemption.

Debate on the corporate minimum income tax cannot possibly proceed on a sensible basis until all parties understand that it is impossible to tax a business corporation except in a limited "first order" sense; this is true of the regular corporate tax, a minimum tax, or any other such levy. As the present occupant of the Oval Office has said many times, corporations don't pay taxes, people do. A corporation is nothing more than a legal arrangement under which individuals conduct business—and, if job creation and growth in living standards over two centuries are any guide, a darned good arrangement at that.

When "second order" effects are considered, it is clear that a business corporation is, in effect, a surrogate tax collector for the Internal Revenue Service. The ultimate payers of tax are the people who buy the corporation's products, work for it and, primarily as stockholders, provide the capital for the company.

To the extent taxes paid by a corporation are passed forward, to consumers, the corporate tax is doubtless regressive. This is because people with low incomes spend higher proportions for their income on the products of corporate America than do people with high incomes, who save more of their income. To the extent that the market for the company's products is weak, as with autos today, the tax must be passed backward to the factors of production. Workers bear part of the burden,

through reduced workweeks and loss of jobs. As dividends are cut back, stockholders, many of whom are not well off at all, bear the brunt. This in turn discourages saving, investment and capital formation. Productivity is damaged and economic growth is hampered.

How much of the corporate tax burden is passed forward and how much backward? Nobody really knows. Some time ago Congressional tax-writing committees made a stab at dealing with the problem by assuming that 40 percent of any corporate tax would be passed through to consumers. This horseback estimate had little basis in logic and in fact greatly underestimated the passthrough in strong sellers' markets and overestimated it in strong buyers' markets. The effort was dropped.

Today no estimates are set forth of the ultimate impact on individuals of proposals to collect more taxes from corporations. Experts say that the Treasury's new minimum income tax would hit 90,000 corporations as contrasted with the 5,500 now affected by the existing minimum tax. It is expected that the new minimum tax would most strongly affect such industries as steel, mining, and electric utilities, industries already in varying degrees of economic trouble, if not distress.

What will be the impact of the new minimum tax on the competitive viability of companies in these industries? On the people who buy from them, work for them, and own them? To what extent will the new minimum tax be passed on as an inflationary, regressive levy on consumers? For electric utilities, probably to a considerable extent; for steel companies, with markets weak and international competition strong, probably only in small measure. And, to the extent the minimum tax on steel companies is borne by stockholders, what is the probable impact on the industry's ambitious plans to spend $7 billion over the next four-to-five years for expansion and modernization?

If I were a member of Congress, these are a few—and only a few—of the questions that I would want answered before casting my vote for a stronger minimum corporate tax or, for that matter, any increase in business taxes. An increase in business taxes would significantly erode many of the capital formation incentives enacted in 1981 and shake business confidence in the staying power of those incentives as well as some enacted in prior law.

Business needs to know it can count on the laws on the books in order to plan for the future with confidence. A firm plans its investment spending programs several years into the future, and thus needs to know with certainty the tax implications of the decisions it makes today.

In addition, we have two specific concerns with the Administration's proposed alternative minimum tax on corporations—the impact on the investment tax credit and on net operating losses (NOLs).

First, recent analysis of th new proposal by Emil Sunley, a former Deputy Assistant Secretary of the Treasury Department for Tax Policy and a member of the ACCF's Policy Committee, has found that the proposed minimum tax, in some cases, would in effect reduce the limitation on the investment tax credit from the 90 percent level enacted by Congress in 1978 to 67.4 percent of regular tax. In other words, the new tax would substantially blunt the incentive effect of the investment credit for corporations—further reducing the willingness and ability of a corporation to invest in needed productive equipment. Dr. Sunley also points out that the major preference items subject to the corporate minimum tax are found in only a few industries. Whether the tax structures of these industries should be altered is a question more correctly addressed separately. In addition, he notes that the tax would have the perverse effect of encouraging tax-induced mergers that serve no useful economic purpose.

It is also the case that even if a corporation has no tax preferences, it may still end up paying the alternative minimum tax under the Administration's proposal. That consequence results because the investment credit cannot be applied in the proposed minimum tax calculation.

Second, the proposed minimum tax would, in some cases, produce results difficult to justify on equity grounds and impossible to justify as policy in the current economic climate.

Rather than being directed solely toward assuring that profitable companies do not, by excessive use of so-called "tax preferences" (credits, special deductions and exclusions from income), escape paying any tax at all, the Administration's proposal imposes a tax where no economic gain exists. As an example, suppose a corporation loses $51,000 in 1982 and, in 1983, has a profit of $51,000 resulting in an economic break-even over the two-year period. The corporation will pay $150 in minimum tax in 1983. Clearly, this makes no economic sense. Even though a portion of the minimum tax paid may eventually be recovered, the impact on a new company starting

up, or on one that has undergone temporary difficulties, can be devastating on the company—and is also bad economic policy.

Thus, the proposed alternative minimum tax would work exactly counter to capital formation needs and, indeed, deny some of the benefits enacted in prior years.

Quite frankly, the ACCF and the business community are split on the merits of any tax increase at this time and, if there are to be tax increases, what kind they should be. I have my personal views which I outlined in testimony presented to the House Ways and Means Committee on February 19, 1982.

The spending side

Major attention in the Congress should be focused on Federal spending relative to GNP, rather than on an attempt to achieve a given Federal deficit in any fiscal year. With any year's deficit subject to wide swings as a result of only small changes in interest rates, unemployment, and the rate of economic growth, the deficit as a target is all too often a will o' the wisp.

However, even with these constraints on Federal budget deficit control, there are a number of alternatives on the spending side of the ledger that should be considered.

For example, several highly respected Members of Congress have suggested that the automatic cost of living adjustments (COLAs) could be frozen or reduced to effect substantial short-run budget savings. Much of the rapid growth in entitlement benefits has resulted from the COLAs. In fact, over the last three years, the CPI, which determines most Federal COLAs, has risen faster than wages so that while entitlement-related retirement benefits have maintained their purchasing power, wages of the working population have fallen in real terms. In addition, the CPI contains a flaw in its treatment of housing costs, which results in overestimating price increases during periods of rapidly rising home mortgage interest rates. Consequently, the CPI has risen faster than other price indexes during the last five years.

For the longer run, the ACCF urges Members of this Committee to support enactment of H.J. Res. 350, the Tax Limitation-Balanced Budget Constitutional Amendment. This Constitutional Amendment would mandate in advance of each fiscal year that Congress adopt a budget statement under which outlays would not exceed receipts. In addition, the annual increase in planned or budgeted receipts would be limited to the rate of growth in national income in the preceding calendar year. As the year progressed, actual receipts would not necessarily equal budgeted receipts; but actual outlays could not exceed budgeted outlays. This would effectively limit the growth in Federal spending to the growth in national income. If a deficit were needed in case of national emergency, Congress could plan a deficit by having the vote of three-fifths of the membership in each House.

The Amendment would allow a deficit to occur in a recession if actual revenues fell short of planned budget receipts. Alternatively, if the economy needed cooling off, Congress could plan for tax receipts to exceed the rate of growth in national income by a vote of a majority of the whole membership in each House and the approval of the President.

The timing proposed by the Amendment would fit nicely with the intent of Congress to restore a balanced Federal budget by 1985 or 1986. Under the timetable proposed by the Amendment, it would become effective in fiscal year 1986.

CONCLUSION

President Reagan is correct in his determination to stick with the fundamental thrust of his economic game plan put in place last year. Unfortunately, we are faced with record high Federal deficits and must reduce them. Our focus should be on spending cuts, not tax increases. If there are to be tax increases, they should be carefully crafted to avoid undercutting the capital formation aspects of ERTA. The proposed new alternative minimum tax on corporations would do just that and, therefore, should not be enacted.

If financial market participants were convinced that these steps were taken to control short- and long-term deficits in earnest—and this would require a strong bipartisan consensus in the Congress—interest rates would decline sharply. The prospect for short-term economic recovery would be greatly strengthened, and the door opened for the increased business investment spending that is the key to restoration of long-term economic expansion.

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STATEMENT OF THE AMERICAN GAS ASSOCIATION

INTRODUCTION

The American Gas Association (A.G.A.) is a national trade association comprised of nearly 300 natural gas transmission and distribution companies serving approximately 160,000,000 consumers in all 50 states. A.G.A. member companies account for approximately 85 percent of the annual natural gas utility sales in our nation.

The Administration's proposed tax revisions and the reduction of investment capital which would result therefrom are of particular interest to A.G.A. member companies because the cumulative captial investment of the natural gas utility industry is projected to rise to the level of $482 billion (1982 dollars) between 1982 and 2000. This figure is an estimate of the amount of capital required by the gas industry to finance the high end of the "North American Focus" supply scenario.[1] In addition to being an estimate of the funds needed to finance supply development, the $482 billion figure includes the amount of capital required to meet pipeline and distribution system maintenance and construction.

In order to develop fully our nation's domestic natural resources and to reduce our dependence on foreign oil, a continued high level of investment is required in natural gas exploration and development projects. To attain this high level of investment and to achieve the above-outlined capital requirements, A.G.A. believes that current tax policy, designed to foster plant modernization and investment in productive assets and projects, must remain intact in order to provide the certainty, predictability and reliability necessary to maintain both industry and investor confidence.

While A.G.A. recognizes the current pressure on the Administration and Congress to reduce the mounting budget deficit, it does not believe that a retrenchment in investment incentive tax policy is the correct means to reduce the budget deficit. For A.G.A. member companies in particular, imposition of a corporate minimum tax in the form proposed by the Administration would work to undermine the value of the major business investment incentives enacted over the past decade, including those created in the Economic Recovery Tax Act of 1981 (ERTA).

It should be noted that the primary benefits granted to utilities in ERTA under the accelerated cost recovery system (ACRS) are not as generous as they are for other industries. In the ACRS, long-lived public utility property is relegated to a recovery period of either 10 to 15 years while the long-lived property of most other industries is placed in a 5 year recovery period. The Economic Report of the President transmitted to the Congress in February of this year shows at page 124 that the effective tax rate for utilities prior to ACRS was 43.2 percent, whereas after ACRS is is estimated to be 30.6 percent. This is an effective rate benefit of just over 12 percent. In contrast, the mining industry had its effective rate lowered by 31.8 percent (28.4 percent to −3.4 percent), primary metals by 26.5 percent (34.0 percent to 7.5 percent), motor vehicles by 37.1 percent (25.8 percent to −11.3 percent), and paper by 27.6 percent (28.5 percent to 0.9 percent). Other industries also received a comparable significant lowering of their effective rates.

CORPORATE MINIMUM TAX PROPOSAL

As the previously cited Economic Report of the President demonstrates, the utility industry has been a substantial tax paying sector for many years with natural gas utilities contributing their fair share of these tax revenues. For many A.G.A. member companies, however, the corporate minimum tax proposal as currently drafted would result in a significantly higher tax liability in 1983 and subsequent years and, thereby, would substantially reduce what is already a comparatively small benefit received from ACRS. Such a tax would effectively undercut current investment incentives, jeopardize future capital investment projects and penalize companies which have relied an current investment incentives. Specifically, many A.G.A. member companies, in making long-term capital investment decisions, relied on their ability to use the investment incentives in the current law, including the investment tax credit (ITC).

Enactment of the current corporate minimum tax proposal would increase the tax burden on the natural gas utility industry and, in effect, would take away the investment incentives that had been relied on the help finance needed capital projects. The corporate minimum tax, therefore, would require companies to obtain al-

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[1] The "North American Focus" supply scenario projects a range of natural gas supply from 26.0 to 32.0 Tcf in the year 2000.

ternative financing and would essentially penalize them for relying on both long-standing and newly-created investment incentives.

Specifically, A.G.A. member company-sponsored projects which have relied on current investment incentives and which would be penalized under the current minimum tax proposal include (but are not limited to) the Alaskan Natural Gas Transportation System project and the Great Plains Coal Gasification project.

Moreover, while the corporate minimum tax proposal does not identify the ITC as a tax preference item, the mechanics of the proposal, in effect, operate to convert the ITC into the most substantial of all the preference items. This occurs because the present law permits the ITC to offset up to 90 percent of tax liability and, any company which fully uses the credit up to this 90 percent limit would invariably be required to pay the corporate minimum tax because that tax would always be greater than the regular tax after the 90 percent offset. This results even though the company may never have used any of the tax preference items which the proposal specifically identifies.

In summary, A.G.A. believes that for the regulated gas industry, the Administration's proposed corporate minimum tax would undermine much of the investment and modernization incentive inherent in the tax laws. Under present law, the business community as a whole, and the regulated natural gas utility industry in particular, were encouraged by what appeared to be a national tax policy designed to stimulate investment in productive assets. This investment climate, which is conducive to economic recovery, should not be jeopardized by imposing a counter-productive corporate minimum tax.

BUSINESS ENERGY CREDITS

A.G.A. believes that repeal of the business energy investment credits as proposed by the Administration would also undermine the energy investment planning and strategy of A.G.A. member companies which have relied on the existence of these business energy credits. At the very least, companies which have made more than de minimis planning and development commitments (such as feasibility, engineering and environmental studies) should be permitted to retain the business energy investment credits otherwise available to them under current law.

ACCELERATION OF CORPORATE TAX PAYMENTS

A.G.A. believes that, for the regulated gas utility industry, the proposal to accelerate estimated corporate income tax payments to 90 percent is unreasonable. Such a requirement is particularly unwarranted for an industry whose monthly revenues and income depend largely on the weather. The day-to-day changes in the weather and temperature can result in substantial and unpredictable fluctuations in utility income. In light of this inability to project income accurately, A.G.A. recommends that no penalty provision be included in any proposal to accelerate estimated corporate income tax payments. Rather, any such proposal should include a simple deductible interest charge in lieu of a penalty for an unintentional understatement of income.

TAX-EXEMPT BONDS

A.G.A. believes that utilities should be exempt from the Administration's proposal to require depreciation of assets, financed with tax-exempt bonds issued after 1982, using the straight-line method over the extended recovery period used for earnings and profits computation purposes. A purpose of this provision arises from a concern over the loss of revenue that would result, in certain circumstances, when ACRS is combined with tax-exempt financing.

In order for utility property to be eligible for ACRS under ERTA, all benefits of ACRs must be normalized in setting rates charged by utilities to customers and in reflecting operating results in regulated books of account. We believe that normalization of ACRS, which is applicable only to utilities, will avoid the revenue loss presumed to be caused by utility use of tax-exempt bonds. Therefore, although we share the concerns the proposal addresses, we do not believe a blanker rule against use of ACRS with tax-exempt financing should be enacted. Rather, utilities normalizing ACRS should be exempt from the proposal since normalization averts the revenue loss which the proposal attempts to control.

COMPLETED CONTRACT ACCOUNTING METHOD

A.G.A. opposes the Administration's proposal to restrict substantially or eliminate the completed contract method of accounting. A.G.A. believes this method has

proven to be an effective and equitable means of recognizing income on long-term contracts. Indeed, the completed contract accounting method has been sanctioned by the Department of the Treasury since 1918 and the regulations, which were developed during the period of 1971 through 1976, explicitly approve the use of the method. Moreover, in practice, it has proven to be a proper method of determining taxable income.

Specifically, the completed contract method has an advantage over any form of percentage-of-completion method in that no estimates are required in determining taxable income or loss each year. Under the completed contract method, tax is paid on the actual profit on a particular contracted job. Under the proposal, however, a loss would be deductible only in the case where costs already incurred exceed total payments to be received under the contract.

The Administration's recommendation is unnecessarily complex in that it contains ambiguities and inconsistencies. Moreover, we do not believe the proposed departure from the completed contract method is justified because the present method of completed contract accounting assures accuracy and provides a reasonably manageable means of determing taxable income.

MODIFICATION OF CURRENT PROPOSALS

If a corporate minimum tax proposal is to be a vehicle to relieve budget deficit pressures, then A.G.A. would recommend the following:

Any corporate minimum tax proposal should include a provision which permits at least a 50 percent use limitation on the investment tax credit with the same carry back and carry forward period as exists under current law. Otherwise, investment tax credits would go unused because the proposed minimum tax credit carry forward is ineffective in preserving these investment credit incentives in the event a company found itself in a minimum tax liability posture for a protracted number of years.

A corporate minimum tax proposal should greatly reduce the amount of intangible drilling costs (IDC) considered a tax preference so as not to frustrate exploration and development of our domestic natural gas resources. The minimum tax could provide a net income offset such as that available to individuals.

In determining the amount of *excess* IDC in any year for individuals, the IDC incurred in that year is generally reduced by a ten-year amortization factor, but not until the year in which the production has commenced. The Administration proposal also allows a ten-year amortization offset, but there is some question whether this offset can be applied against the IDC of all properties, or must be applied on a property-by-property or well-by-well basis. For example, if a corporation incurs $5 million of IDC on a well in 1983 and is still drilling that well in 1984, there would be no amortization offset allowed for 1983. Thus, the full $5 million of IDC would be a 1983 tax preference item. If the well is completed and begins production on September 1, 1984, after incurring additional IDC in 1984 of $2 million, then 4/120 or 3.3 percent of the $2 million (rather than $7 million) would seemingly be allowed as an offset against the IDC added to the minimum tax base for 1984. Although amortization is presumably allowed against IDC incurred for that well in subsequent years, IDC incurred after a well starts producing is generally minimal. Thus, there will apparently be no amortization of IDC in a later year.

If IDC is to become a tax preference item, it should be provided that the unused 120-month amortization offset of the total IDC incurred (i.e., $7 million) can be utilized as an offset against IDC incurred in drilling other wells. If such treatment is denied to the taxpayer, then the benefit of the amortization offset is without substance, since: 1) there will be little, if any, IDC after production has started; and, 2) there will be no IDC offset where substantially reduced production causes a well to be abandoned in a subsequent year, before the costs attributable to that well have been recovered.

CONCLUSION

A.G.A. believes that the corporate minimum tax proposal as currently drafted would undermine investor confidence and industry reliance on both long-standing and newly-created investment incentives. A.G.A. offers its resources and facilities to assist in forging a workable solution to the difficult budgetary questions facing Congress, the Administration and our nation.

Statement of the American Hospital Association

The American Hospital Association, which represents over 6,300 member hospitals and more than 35,000 personal members, appreciates the opportunity to present its views on the Treasury Department's proposal to enact restrictions on the use of tax-exempt bonds by hospitals.

Two aspects of the Department's proposal are of great concern: the restrictions on private not-for-profit hospital use of tax-exempt bonds, and the limitations on investor-owned hospital use of "small issue" industrial development bonds.

What we know of the proposal is derived from Secretary Regan's testimony before this Committee on February 22 and a detailed statement issued by the Treasury Department on February 26. As we understand it, actual legislation has not yet been transmitted to Congress.

TAX-EXEMPT BONDS

Based on available information, AHA is strongly opposed to the application of restrictions on hospital use of tax-exempt bonds. It is inappropriate to impose yet another burden of proof that hospital projects are public purpose projects, and it is counterproductive to force hospitals to use more costly capital financing methods at a time when the federal government is trying to restrain health care cost growth, particularly in Medicare and Medicaid.

Tax-exempt financing is vitally important to minimizing the cost of hospital capital projects. From 1971 through 1981, the value of hospital bonds issued grew from $0.26 billion to $5.04 billion. In 1981, hospital bonds accounted for 11 percent of the total long-term, tax-exempt volume of $45.7 billion. In general, the interest rate for tax-exempt bonds is about 3 percentage points lower than comparable taxable obligations. During part of 1981, there was as much as a 30 percent differential between interest rates for tax-exempt and taxable bonds.

It is not true, as some have intended, that the growing use of tax-exempt financing by hospitals has contributed to a growth in capital expenditures. In fact, there is no demonstrated relationship. During the period 1973 through 1979, when the proportion of hospital construction financed with tax-exempt bonds rose from 21 percent to 49 percent, private hospital construction spending was relatively stable, rising from $3.05 billion in 1973 to $4.3 billion in 1979 (our most recent data). When inflation over that period is considered, the real value of hospital construction actually dropped to $2.6 billion in 1979.

Hospitals have turned to tax-exempt bonds to replace other sources of financing which have dried up, such as government programs and philanthropy. If tax-exempt financing is restricted, hospitals will turn to yet other sources, primarily the taxable market, which are more costly. The markets view non-profit hospitals as a less desirable long-term risk, because of the increasing revenue shortfalls caused by government policies; thus, hospitals pay a premium in higher interest rates and shorter terms.

The Treasury Department's stated goals are to increase federal income tax revenues and reduce pressure on the municipal bond market. Under the proposal, these goals would be addressed by imposing a series of conditions ostensibly intended to assure that projects financed with tax-exempt bonds meet a public need. By including hospitals in its proposal, the Treasury Department reveals its shortsighted concentration on revenue enhancement, to the exclusion of another crucial policy issue—health care costs. Moreover, the Department has revealed its ignorance of the existing heavy regulation of hospitals and their capital expenditures which ensure their public purposes. Finally, the Department misunderstands the role tax-exempt financing plays in hospital projects.

Under the Department's proposal, eight conditions would have to be met, in addition to those now in law, for the use of tax-exempt financing by nonpublic entities. Two of these conditions clearly are inappropriately applied to hospitals and would seriously impede access to tax-exempt financing;

—The requirement that each bond be specifically approved by an elected unit of government or by referendum; and

—The requirement that, after 1985, the unit of government issuing the bond contribute 1 percent of the project cost, either directly in cash, or indirectly by tax abatement, services provided, bond guarantee, etc.

Two other conditions are, at a minimum, sources of concern to hosptials:

—The requirement that all tax exempt bonds be registered; and

—The limitation imposed on arbitrage income derived from short-term investment of bond proceeds.

Bond approval

By requiring specific approval of each hosptial-related bond by the highest elected official or body, or by referendum, this proposal would add another unnecessary and pointless requirement to the already closely regulated process of approving hospital capital projects.

With the existing combination of government oversight, can there be any doubt that an approval hospital capital project meets every conceivable local, state and federal government test of public purpose? This new approval is inappropriate because:

—By federal and state law, all sizeable projects are subjected to certificate-of-need review, which includes public hearings;
—In all states but one (Ohio), hospitals are licensed to operate;
—Virtually all hospitals participate in Medicare and are therefore subjected to conditions of participation and certification;
—Most hospitals undergo voluntary accreditation by an independent organization; and
—Two-thirds of private, nonprofit hospitals received federal construction assistance under the Hill-Burton program.

Approval of bonds by elected bodies will only delay projects that already have been thoroughly reviewed and approved, thus adding to the expense of securing approval and adding to project costs, which in turn will be paid by the public who use the hospitals.

Financial contribution

By requiring a substantial contribution from the unit of government issuing the bond, the Treasury Department's proposal effectively would restrict hospital tax-exempt financing to localities which can afford to contribute, and deny it in those areas where governments are under severe fiscal constraints, despite the demonstrated need for the hospital capital project. This federal rationing of tax-exempt financing would bear no valid relationship to "public purpose." Hospitals, whether public or private, are important community resources, with a significant—and sometimes exclusive—role, in meeting public health care needs. This is particularly true in rural and inner city areas in which financially strapped governments would be least able to meet the Treasury Department's contribution test.

For the elderly, poor, and unemployed in such a locality or state, denial of tax-exempt financing to the local private nonprofit hospital would increase health care costs. The proposal also would retard economic recovery and exacerbate the government's fiscal problems. For hospital projects, which all have a well-established public purpose, this requirement is inappropriate and counterproductive.

Bond registration

While AHA does not disagree with the Department's goal of tracking sale of bonds for tax purposes, it must be pointed out that bond users (e.g., hospitals) commonly are required to pay any registration costs, which can be significant. The committee should consider whether the value of registration outweighs the added costs to hospital capital projects.

Arbitrage Limit

Since the details of the proposal are not available, it is difficult to make a definitive comment. However, we must point out that Medicare currently imposes an arbitrage rule, which may make the Treasury Department's proposal duplicative, or even contradictory. We recommend that the Committee examine this aspect of the proposal in the light of current Medicare policy.

SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS

Small issue industrial development bonds (IDBs) have played a relatively minor role in hospital capital finance, accounting for about 1 percent of total tax-exempt financing for hospitals, chiefly for investor-owned facilities. However, the availability of IDBs has been very important for those capital projects.

AHA understands the importance of enacting reforms in the use of IDBs, but believes that since the abuses which have been identified do not involve hospitals, the proposed limitations on use of IDBs are inappropriate for hospital projects.

Hospital capital projects are clearly in the public interest, as has been explained earlier in this statement. Given their importance to some hospital projects, IDBs should continue to be available to those hospital organizations who desire to use them.

STATEMENT OF T. LAWRENCE JONES, PRESIDENT OF THE AMERICAN INSURANCE ASSOCIATION

SUMMARY OF TESTIMONY

1. The Economic Recovery Tax of 1981 signalled a major shift in federal tax policy. In lieu of the tax reform measures of the 1970's, the Congress adopted new incentives for savings and investment designed to provide capital necessary to increase productivity, expand employment, and make our products and services more competitive in international and domestic markets.

2. The prospect of future benefits from these new policies is clouded by projections of a large federal deficit. The concern about the impact of the deficit upon financial markets is legitimate. But in designing a strategy for control of the deficit, we believe it is important not to abandon the basic principles of the policies adopted only last year.

3. We urge that Congress pursue cuts in spending as an alternative to increases in corporate and personal taxes which would blunt the effect of last year's changes.

4. The Association strongly opposes the corporate minimum tax proposed by the Administration. We are concerned that the minimum tax will impose a drain on cash flow of corporations in cyclical industries just as they begin to recover from loss periods. Business cycles in the property-casualty industry have typically extended for five to seven years, with the return to widespread profitability marked by sharp competition among companies for market share. To impose an additional tax burden at the first of recovery may distort the traditional course of this cycle.

5. We are concerned that the imposition of the minimum tax will continue the shift of the corporate tax burden from capital intensive to labor intensive industries. Benefits from the accelerated depreciation provisions—the centerpiece of last year's corporate tax reductions—were allocated primarily to capital intensive industries. We fear that the addition of the minimum tax will further distort the relative burdens of various industries. in view of the contributions of service industries like insurance, banking and real estate to the economy (see chart) and their growing importance to international trade, we believe it is difficult to justify further alteration of the corporate tax burden upon various industries.

6. The Administration's proposals to increase the minimum deposit of estimated corporate taxes presents special problems for property-casualty insurers. Under current law, large corporations can avoid a penalty for underpayment of estimated taxes only by paying 60 percent of the amount due. The minimum would be raised to 90 percent in 1986. For property-casualty insurers it has proven virtually impossible to predict the year's earnings accurately enough to satisfy the deposit requirements for the first quarter. Fluctuations in claims incurred and the difficulties in collecting data from a large number of widely dispersed sources make it impossible to project annual results on the basis of data as slight as that received during the first quarter. We ask that increases in the minimum payments necessary to avoid penalties be applied to the three later quarterly payments only, with the first quarter's payments carved out at some lower level, such as the current 60 percent.

STATEMENT

Mr. Chairman and members of the Committee, I am T. Lawrence Jones, President of the American Insurance Association, a trade association representing 152 property and casualty insurers which write approximately one-third of the property-casualty insurance premiums in the United States. I am pleased to have this opportunity to comment upon the Administration's tax proposals that the Committee is considering as part of its review of tax and spending measures for fiscal year 1983.

The economic climate

Last year, when this Committee considered the various tax proposals which became the Economic Recovery Tax Act of 1981, it was faced with grave economic circumstances. The expenditures of the federal government had grown rapidly over the previous decade, outpacing the growth of the GNP. In fiscal year 1980, for example, federal expenditures rose by more than 17 percent over the previous year, while GNP rose only 8.8 percent. The continued requirements for federal revenue placed growing demands upon individuals and business for additional tax revenues.

By fiscal year 1981, federal tax receipts amounted to 21 percent of GNP, the highest ratio since World War II. As the federal sector grew its financing and taxing activities drained income from capital investments necessary to maintain the nation's productive capacity.

Both inflation and high interest rates impaired the healthy growth of the economy. The willingness of Congress to deal with these deep-rooted problems was demonstrated by the enactment of significant cuts in federal spending and much needed incentives for savings and investment in the tax law. It appears that the increases in federal spending, which had appeared to be almost uncontrollable, have been checked. The Congressional Budget Office estimates that federal expenditures will rise by only 12.6 percent in fiscal year 1982, and 9.3 percent in fiscal year 1983, a welcome drop from the 17.4 percent increase of fiscal year 1980 and the 14 percent of fiscal year 1981.

These reductions have been followed by a heartening reduction of the rate of inflation in the past few months.

The redirection of federal economic policy was accompanied by significant changes in federal tax policy. The Congress sought to promote capital investment, expand employment, and make American goods and services more competitive in world as well as local markets, through new incentives for business investment—principally accelerated depreciation and investment credit measures—and individual savings—the expanded IRA's and "All Savers" certificates. These shifts in tax policy were intended to chart a course for business planning over the next five years, at a minimum, and, if economic conditions warrant, for an even longer term.

Our member companies have welcomed these new directions in tax policy and believe the Administration's commitments to reduce the growth of the federal budget and to provide tax incentives to business development are essential if we are to restore the health of our economy.

The pressures created by the deficit

But the prospect of benefits from this new course is clouded by projections of a federal deficit of $90 and $120 billion, in the estimates of the Administration and the Congressional Budget Office. A deficit of this magnitude creates such concern in financial markets that the course charted last year is threatened by measures proposed for its reduction.

We believe these concerns are legitimate. Low rates of growth in the GNP over the last decade have shown that the economy can no longer bear the costs of ever-expanding government financing or steadily increasing taxes.

But in designing a strategy for control of the deficit, we believe it is important not to abandon the basic principles of the policies adopted only last year. The fundamental of the new tax and economic policies are sound. Reducing the burden of corporate taxes and continuing the new savings and investment incentives are essential.

While these policies are expected to produce substantial improvements in the economy in the near future, it would be premature to expect to see their full benefits in the most recent monthly indices. The form and scope of these investment incentives should be maintained if business planners and private investors are to feel that they can rely upon projected returns from investments. Investors such as insurance companies, whose reserve calculations depend upon projections extending over a number of years, cannot afford to make commitments that depend upon current savings and investment incentives when it appears that these incentives may soon be eliminated or reduced.

We urge that Congress pursue cuts in spending as an alternative to increases in corporate and personal taxes which would blunt the effect of last year's changes. Careful examination of all federal programs is needed, particularly the proposal for rapid increases in the defense budget. While few Americans question the need for a strong defense, there are many who wonder whether such a rapid increase can be managed efficiently.

The minimum tax

The Administration has proposed eight changes in the law to raise additional revenue. Two of these would have an adverse impact upon property-casualty insurers—the alternative minimum tax on corporations and the accelerated deposit requirements for estimated corporate income taxes.

The Administration proposes to replace the current add-on minimum tax with an alternative minimum tax for corporations equal to 15 percent of their alternative tax base in excess of $50,000. The new minimum tax base would be composed of a corporation's regular taxable income plus certain preference items.

However, in computing the corporate minimum tax base, no deduction would be permitted for net operating loss carryovers and carrybacks. Although credits for the minimum tax paid would be permitted, the amount of any NOL carryover or carryback allowable in computing the regular corporate tax will be deemed to be "ab-

sorbed," according to the Administration, "even in years in which the corporation pays the corporate minimum tax instead of the regular tax."

By disallowing the net operating loss deduction, the designers risk imposing the minimum tax on a marginally profitable corporation or one which is only beginning to recover from a loss period. For a cyclical industry like property-casualty insurance, this unwillingness to recognize a corporation's real economic circumstances may force a corporation to pay an additional tax at a time when it would be more desirable to allow it to recover from its losses.

Assurances that the amount of tax collected under the proposed minimum tax and the regular corporate income tax will be the same as under the current law—the argument that these changes represent a mere "timing" change—overlook the impact of the tax on a corporation's cash flow. Contrary to the clear intent of the economic and tax policies adopted last year, funds which might have been devoted to investments in plants and equipment will be diverted.

Individual companies in our Association have found that the new minimum tax may be imposed upon them just at the time when it is most difficult to assume—in the early years of recovery from a loss period. Business cycles in this industry have typically extended for five to seven years, with the return to widespread profitability marked by sharp competition among companies for market share. To impose an additional tax burden at the first sign of recovery may distort the traditional course of this cycle. Viewed from managements' perspective, the period of marginal profitability will only be prolonged.

While the impact of the minimum tax upon the business cycle and company operations is a source of particular concern to us, we cannot help but be dismayed by the shift in distribution of the tax burden among industries, as well. The accelerated depreciation provisions adopted last year were designed to benefit primarily manufacturers and other industries requiring substantial investments in plants and equipment. Only a small percentage of these benefits were allocated to financial and service industries.

Yet the contributions of service industries such as insurance, banking, finance, and real estate to the economy are substantial. They rank behind only manufacturing and distribution (wholesale/retail trade) in terms of their share of GNP (see chart attached). In 1979, the latest year for which Department of Commerce statistics were available, banking, insurance and real estate accounted for 14.4 percent of the GNP.

Our members are concerned that tax changes intended to restore productivity do not result in an inequitable—and perhaps unintended—redistribution of the corporate tax burden among industries. Benefits from the new accelerated depreciation provisions—the centerpiece of last year's corporate tax reductions—were allocated primarily to capital intensive industries. The minimum tax is expected to fall upon service industries as well, to an extent which the Treasury concedes is difficult to specify. The distribution of tax benefits and burdens among industries, if these two measures are considered together, is unquestionably a source of concern to our members. While we have supported the Administration's efforts to promote investments and restore productivity, we believe that it is critical that the Congress not shift a disproportionate share of the corporate tax burden to financial and service industries.

Accelerated deposit of estimated taxes

The Administration has proposed that the minimum requirement for deposit of estimated corporate taxes be increased yet again. Amendments to the deposit requirement added in 1980 and 1981 set progressive increases in the minimum amounts due if a corporation is to avoid the payment of penalties. Although the statute provides three exceptions which would relieve a corporation of penalties, large corporations (those having over $1 million of taxable income in any of the three preceding taxable years) can satisfy the deposit requirement only if they pay a fixed percentage of their tax liability for the current year. For 1981 the minimum is set at 60 percent. By 1984 it is scheduled to rise to 80 percent. The Administration proposes to increase the minimums to 85 percent in 1985 and 90 percent in 1986. Installment payments of the estimated tax are due on the 15th day of the 4th, 6th, 9th, and 12th months of the year.

With the removal of two of the exceptions to the penalty and the steady increase of the minimums required, corporations which wish to comply with the deposit requirement are faced with a need to predict income, losses, and earnings with speed and accuracy. For property-casualty insurers, however, it has proven difficult—indeed, impossible—to predict the year's earnings accurately enough to satisfy the deposit requirement for the first quarter.

Even with sophisticated management information systems, the data produced during the first three months of the year does not provide an adequate basis for projections of the year's results. Moderate and large-sized insurance companies receive premiums through a network of agents and brokers spread throughout many states. Claims, too, are evaluated and paid through widely dispersed claims settlement representatives. These reports from the field, which are the basis for projections of underwriting income and losses, are difficult to assemble because the sources are numerous and widely dispersed.

It is also the practice in the industry for pools and associations not to report on underwriting activities for the first six months of the year. Companies which receive a substantial portion of their business through pools and associations and foreign agents and brokers are simply unable to estimate the size of tax payment necessary to avoid penalties.

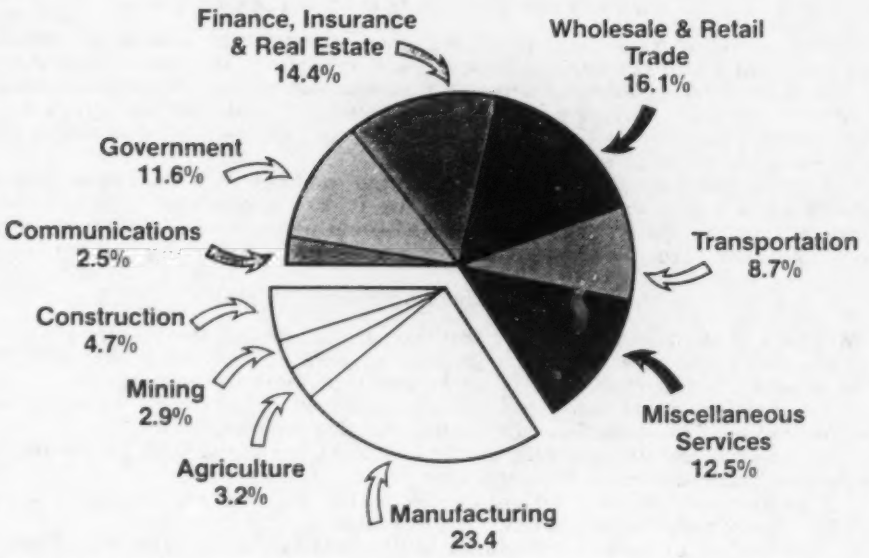
Finally, payments of corporate tax are difficult to estimate in the first quarter because insurers are subject to wide fluctuations in losses incurred during the third and fourth quarters which may turn an otherwise profitable year into a loss. Catastrophic losses—a hurricane on the Gulf Coast, the loss of an oil drilling rig or a jumbo jet, a court's verdict in a precedent-setting class action—are only a few examples of losses incurred in the third and fourth quarters which may upset an insurer's earnings projections.

Our member companies's inability to collect sufficient first quarter data is not caused by an unwillingness to comply or a failure to institute necessary information gathering systems. But fluctuations in claims incurred and the difficulties of collecting information from a large number of widely dispersed sources make it impossible to predict annual results on the basis of data as slight as that received during the first quarter. Current law forces many companies to make the hard choice between a penalty and an overpayment in the first quarter. Raising the minimum from 60 percent to 90 percent will make this an even greater hardship.

If the Committee should decide to adopt the Administration's proposal to increase the deposit requirement even further, we ask that the increase be applied to the three later quarterly payments only, with the first quarter's payment carved out at some lower level, such as 60 percent.

As an alternative recommendation, we ask that the Committee permit a longer period for taxpayers to compute the first quarter payment. Imposing nondeductible penalties for underpayment of estimated taxes upon businesses that have made good faith efforts to comply seems neither fair nor reasonable.

COMPOSITION OF GROSS NATIONAL PRODUCT
1979



Shaded Areas=Services

Source: U.S. Dept. of Commerce, Bureau of Economic Analysis

STATEMENT OF THE AMERICAN PAPER INSTITUTE

The American Paper Institute (API) welcomes the opportunity to comment on the President's tax proposals.

API has over 175 members which provide more than 90 percent of the pulp, paper and paperboard manufactured in this country. Paper and allied products rank among the ten largest industries in the United States will revenues close to $80 billion.

The Economic Recovery Tax Act (ERTA) of 1981 was enacted to encourage savings and investment and provide a base for increasing the efficiency of U.S. industry while promoting growth. These basic requirements remain in the system. The current recession only confirms the need to pursue fiscal policies that encourage economic growth. The tax program enacted last year is still relatively new and must be given time to show its effectiveness.

Consequently, we urge the Ways and Means Committee to keep in place the savings and investment incentives which formed the basis for the ERTA.

The pulp, paper and paperboard industry is one of the most capital intensive in the United States. Its capital outlays this year will be close to $7 billion; we project its annual capital needs at $12.5 billion a year in the years 1985-1990. If the industry is to meet the potential needs of both the domestic and international markets in those years, it must make investment decisions now. API estimates that the accelerated capital recovery provisions that are part of the Economic Recovery Tax Act of 1981 will contribute an additional $1 billion a year to the industry's internal funding of capital requirements in 1985–1990.

The incentives provided in ERTA are only now beginning to work. To alter them would compound the effects of recession and cause more delays in capital projects.

The news that business is scaling back some capital spending plans may lead to the mistaken conclusion that the capital incentive program is not working.

The real factor behind the curtailment in capital expenditures is reduced profits which in part reflects high interest rates and the fact that, in the early stages of disinflation, prices move down faster than costs. Removing or postponing incentives now would only hurt.

THE NEED FOR STABILITY IN CAPITAL PLANNING

Capital spending decisions depend upon many factors that have to be evaluated and predicted. Future demand, the adequacy of return on the investment, the availability of funds from internal sources such as after-tax profits and depreciation, and conditions in credit markets must all be evaluated and predicted over a period of 10 to 15 years. The inherent risks in this process have been multiplied in recent years by the volatile nature of government policies.

The present attempt to alter the tax program even before it has had a chance to take effect is a good example of the negative effect on long-term investment decisions of uncertain government policies. One could understand a mid-course correction in business taxes if they were a major contributor to the problem. They are not.

THE DEFICITS PROBLEM

Members of the American Paper Institute are mindful of the problems with the President's budget message which projects sizeable deficits continuing into 1987. This prospect is alarming to all of us. It does contribute to the unnecessarily high interest rates prevalent today and affects confidence in the future. Here are some factors that need to be considered in evaluating this problem:

1. The higher deficits projected in 1983's budget compared with last year's estimate result almost entirely from recession induced factors:

(a) Revenues in fiscal 1983 are projected $51 billion lower because of a lower forecast of dollar values of GNP and inflation;

(b) Higher unemployment adds $8 billion to the expected outlays for 1983;

(c) Higher interest payments and debt contribute another $31 billion to projected outlays for fiscal 1983.

Consequently, the solution must be one that fosters and contributes to faster growth. This clearly indicates that tax policies must be carefully evaluated at this time to ensure that growth is not hindered by tax changes and the recession lengthened.

2. Notable progress in spending cuts was made in 1981, but major follow-up actions are needed in 1982. Congressional committees have not, to date, seriously come to grips with the need to reduce the rate of increase in government spending. There are no indications, however crude, that a spending figure approximating the President's total is close at hand. We believe everyone, consumers as well as investors, would be encouraged if at least some progress toward a curtailed rate of government spending could be made now. This could change the expectation component in interest rates. The pressing problems of entitlement programs may not lend themselves to adequate and fair solutions in the present crisis atmosphere. Long range and permanent solutions are needed for the chronic problems associated with these programs.

Real and credible progress on these issues, however small, in the present session of Congress will convince investors that the nation is on the right track.

3. Savings have increased since the first small stage of tax cuts for individuals went into effect on October 1, 1981. The second stage of the tax cut particularly conducive to traditional savings outlets went into effect only on January 1, 1982, when the maximum rate on investment income dropped from 70 to 50 percent, and the new provisions for Individual Retirement Accounts were introduced. These tax initiatives have in part been blunted by the recession; their positive impact should not be minimized by this temporary situation.

The third stage, to take effect on July 1, 1982, should show an even more convincing response of savings to taxes. A significant change in the present tax policy now would be a premature judgment of the existing one.

Yes, it is taking time, but the failures are not in the program but rather in those forecasters who overstated its impact.

CURRENT BUSINESS TAX INCREASE PROPOSALS

The Administration has proposed a number of tax increases, under headings such as "Selected Tax Revisions" and "Improved Tax Collection and Enforcement." Included in these proposals are the "revenue enhancing" measures outlined in September, plus some additional increases.

Our support of the President's tax program includes necessary selective tax revisions and changes designed to eliminate abuses and correct unintended loopholes.

The problem is that the provisions affecting industry, in the aggregate, would take back as much of 50 percent of the corporate tax reductions provided by the Economic Recovery Tax Act of 1981 (the corporate tax reduction in the ERTA amounted to only about 20 percent of the total estimated cut).

Our specific comments on the Administration proposals point up some problems.

Minimum tax

We oppose the Administration's new alternative minimum tax proposal. This minimum tax concept has the potential of seriously impairing the effectiveness of the investment incentives already in place and could have long range detrimental effects on capital formation. These incentives which are designed to speed up the rate of new capital formation are needed if industry is to increase its stock of capital goods more rapidly in the years ahead than in the previous decade.

Here is one of many actual examples of the detrimental effect of the minimum tax. In December, 1981, a company announced plans to build a new mill at a cost of close to $600 million. Financing this mill is based in part on the internal cash flow made available by the use of the investment tax credit and the accelerated cost recovery system. These sources of cash flow would be reduced if this company were subject to the minimum tax. The project then would have to be funded through higher borrowings which would add substantially to its cost and result in delays. The real question is "Will this company undertake such an investment given the constraint over internal cash flow which results from the application of this minimum tax concept?"

Energy credits

Our industry's record on energy conservation resulting from accelerated investment in energy conservation facilities has justified its use of energy tax credits under existing legislation, which includes a sunset provision with appropriate transition rules. The Treasury Department, however, has proposed a restrictive transition rule as part of its repeal of all business energy tax credits, effective January 1, 1983. We cannot support this new rule which would in effect impose retroactive penalties on taxpayers who have relied on existing law and transition rules.

Tax exempt bonds

We urge that tax exempt bonds continue to be available for pollution control financing and that facilities so financed continue to qualify for accelerated depreciation. Our industry has made excellent gains in reducing environmental pollution; use of tax exempt bonds for financing mandated, non-revenue raising pollution control facilities has been a key factor in this progress.

Safe harbor leasing

The flexibility provided by safe harbor leasing is an essential element of equity in the accelerated cost recovery system. The industry supports its use, particularly for capital intensive industries like ours, which have temporary earnings situations that prevent it from otherwise taking advantage of the investment incentives provided by the Economic Recovery Tax Act of 1981.

The public evalution of safe harbor leasing stresses the benefit to companies with earnings, while minimizing—and even ignoring—the capital spending benefits to those companies experiencing temporary reductions in cash flow. Forest product producers, who operate in both the housing and paper industries, are a good case in point. Their building product earnings have been hard hit by the slump in housing and yet they find a need to continue to spend in the paper segment of the business. The leasing arrangements have helped some of them minimize the adverse effect of reduced overall cash flow on the required investment in new paper capacity. Clearly, without safe harbor leasing these companies would have had to defer some capital outlays. We therefore urge that these benefits be fully evaluated in the current review of safe harbor leasing, and that this review focus on identifying and correcting any specific "abuses."

Accelerated tax payments

One element of the proposal to accelerate corporate income tax payments is troublesome. This proposal would increase the required estimated tax payments from 80 to 90 percent of the current year's tax liability and would impose a severe penalty for underpayment. Compliance within a narrow 10 percent range would be extremely difficult. Estimates of annual operating earnings, tax depreciation and investment tax credits are educated guesses in the earlier portion of the year. Even post

year-end decisions, such as those relating to pension expense deductions, could result in an inaccurate estimate of the tax liability during the tax year.

SUMMARY

In summary, progress on federal spending restraint is the most significant need in business expectations; selective revenue enhancing proposals are also needed.

We see no immediate danger to the economy or to inflation from deficits in 1982 and 1983. Beyond that, the balance will be determined by events that cannot be foreseen at present. Very difficult decisions must be made on the spending side. If they require more time for review and consensus than now exists, Congress ought to at least address the matter of achieving spending targets close to those established by the Administration as a first step. Additional cuts can be made later.

To raise taxes now would signal that Congress cannot discipline itself to do what the public seems to want; control spending and reduce taxes.

STATEMENT OF THE AMERICAN PETROLEUM INSTITUTE—THE ADMINISTRATION'S PROPOSAL FOR A CORPORATE MINIMUM TAX

SUMMARY

I. Petroleum industry profitability, capital expenditures, and taxes

A. Current petroleum situation.—Oil demand and are falling. The industry's tax burden is up sharply. Profitability is down. Capital investment plans are necessarily being reevaluted and sometimes cut back—after being increased sharply in response to higher prices and profitability. Yet, the industry' success in reversing the decline in U.S. production and diversifying foreign sources of supply is jeopardized by proposals for increased taxes, even though it would be premature to conclude that the oil crisis is over.

B. Movement of oil industry profits.—There is a widely held misconception that oil industry profits move only up. Those who argue that profits are ever-higher ignore profitability (the relationship of profits to investment) and inflation. Moreover, profits have sometimes risen and sometimes fallen. Recently, they have been falling.

C. Profitability.—Rate of return on investment is a far more significant indicator of performance than the absolute level of profits. Despite the high risks of petroleum exploration, oil company returns on shareholder equity have been well above non-oil manufacturing returns in only four years since 1968 (1974, 1979, 1980 and 1981). In 1981, oil rates of return began falling once more.

D. Capital expenditures.—Increased profitability provided both an incentive and source of cash for increased captial outlays. Oil companies responded with a massive increase in investment—from about $10 billion per year in the arly 1960's to about $60 billion per year (annual rate) early in 1981. Decreasing profits have, however, led to reductions in planned expenditures. Only about 6 percent of oil company capital expenditures have been for facilities outside the enrgy and petrochemical fields. Petroleum companies reinvest 67 percent of their funds, in contrast to 56 percent for non-oil manufacturing.

E. Tax burden.—The pertroleum income tax burden for 1981 was comparable to that other companies—about 38 percent. However, windfall profit taxes raised that figure to 57 percent—exclusive of state severance taxes and deferred income taxes, which are high in industries (such as petroleum) that are captial intensive.

II. The administration's proposed corporate minimum tax

A. In general.—1. The Administration's proposal would erect a barrier to new investment for taxpayers placed in a Corporate Minimum Tax (CMT) position inasmuch as the current after-tax cost for each dollar of incremental investment would increase from $.54 under present law to $.85 for non-preference expenditures and $1.00 for preference items.

2. The proposed CMT would not allow full cost recovery thereby artifically inflating income and placing the taxpayer in a worse position in many instances than if the preference had not been allowed. In such cases, the CMT would tax the recovery of capital. Moreover, as long as taxpayer remains subject to the CMT, all current benefit of the investment tax credit (ITC) would be lost on incremental investment.

3. Loss of the ITC and full cost recovery discourages new business investment in plant and machinery contrary to the goals under the Economic Recovery Tax Act of 1981 (ERTA), thus slowing or even precluding recovery in many depressed industries. New companies with low profits and high start up costs would be particularly hard hit and may not survive.

4. The proposed CMT contains many technical defects and is contrary to the Administration's goal of simplicity.

B. Intangible drilling and development costs (IDC's).—1. Since current expensing of IDC yields results similar to 5-year ACRS plus ITC which are not treated as preferences for CMT, there is no justification for treating IDCs as a preference item. Under the Administration's proposal, oil and gas producers are not offered a choice of using the preference or electing 5-year ACRS with ITC for each property and avoiding the preference detriment, as other corporate taxpayers are permitted to do in the case of existing timing preferences. Moreover, corporate producers would be denied the offset for oil and gas net income available to individuals.

2. The proposed treatment of IDCs as a preference item to be added to the CMT base fails to recognize that current expensing of capital costs was generally accepted in 1981 as the standard against which any capital cost recovery system should be measured. While Congress ultimately chose five-year ACRS as the recovery mechanism for most machinery and equipment, it was with the knowledge that when combined with the 10 percent ITC, five-year ACRS yielded about the same present value tax effect as current expensing.

3. The additional after-tax costs imposed under the CMT with respect to IDCs would substantially curtail drilling, preclude completion of many marginal wells and reduce available reserves and production particularly with respect to high risk exploratory prospects.

C. Percentage Depletion.—The last vestiges of percentage depletion on oil and gas now available to independent producers and others would be further reduced by the CMT. Using historical cost as the criterion for the preference fails to recognize the erosion of capital values that has taken place through inflation and fails to recognize the increasing real cost of replacing existing reserves.

D. Foreign Operations Under the Proposed Minimum Tax.—The credit against CMT for foreign taxes paid fails to protect U.S.-based companies adequately from additional U.S. tax on foreign-source income in all instances. To the extent U.S. companies are forced to pay higher taxes on foreign income than their foreign based competitors, the U.S. will continue to lose its position of prominence in the world's economy.

CONCLUSION

Overall, the CMT, likes its predecessors, is a poorly conceived attempt to raise additional revenues under the guise of fairness. In effect, it is a tax on corporate investment, and in many instances will tax the "beneficiary" of the so-called tax "preferences" with effective rates greater than if no preference existed. Moreover, the impact of the CMT is counterproductive to the investment goals contained in ERTA to spur business expansion, create U.S. job opportunities, and increase exports.

I. Petroleum Industry Profitability, Capital Expenditures, and Taxes

A. CURRENT PETROLEUM SITUATION

The world oil industry is in a slump. Oil demand and oil prices are falling. Current oil consumption in both the U.S. and other industrialized OECD countries is about 15 percent below its peak level in 1978.

The result is that oil is being sold unofficially at $4 to $6 a barrel below OPEC prices, and more and more analysts are questioning OPEC's ability to maintain its basic price of $34 a barrel. In constant dollars, current Rotterdam spot prices are about 40 percent below the heights reached during the 1979–80 oil crisis.

The profit outlook for oil companies is similarly bleak. Stock prices for U.S. oil companies have led and exceeded the present market downturn. On average, major oil company equities have fallen about 50 percent from their 1980 highs, significantly more than the 20 percent decline in the general market. Investors are concerned that expenditures made by oil companies in anticipation of continually high and rising oil prices could be unprofitable with further erosion of demand and price cutting.

The oil companies are reassessing their operations. While outlays on oil exploration and development proceeded at record high levels during 1981—double the 1978 spending level in current dollars—current and future investment plans are now being reevaluated and sometimes cut back, especially when they involve high-cost energy from unconventional sources or frontier regions. Capital appropriaitons for new projects declined 20 percent from the third to the fourth quarters of 1981. After peak activity in 1981, there is also a decline in drilling rigs now working in the

United States, as well as a slide in seismic exploration, the first stage in the search for oil. And to accommodate lower current and prospective oil demand, companies are closing refineries, reducing inventories, trimming the number of marketing outlets, and continually looking for new ways to cut costs.

In the face of receding demand and falling profits, the taxes paid by oil companies continued to rise. U.S. income and Windfall Profit Tax [1] (WPT) liabilities incurred by a representative group of oil companies grew to $26 billion in 1981 from $16 billion in 1980. Because U.S. income before these taxes rose at a slower rate, the oil companies' effective U.S. tax rate (current U.S. income taxes plus the U.S. WPT divided by income before such taxes) increased from 32 percent in 1979 to 43 percent in 1980 and 57 percent in 1981. In contrast, the average effective income tax rate for all U.S. corporations (current taxes divided by pretax income) remained at about 37 percent throughout the 1979–81 period. And this relative industry tax burden does not reflect the practice of state and local governments of taxing U.S. oil producers more than other kinds of companies. In particular, it excludes the billions of dollars of severance taxes and property taxes on oil and gas reserves paid by U.S. oil producers.

Total WPT collections in the United States increased from $10 billion in 1980 to about $28 billion in 1981 (before allowance for income tax offset). In combination with other federal and state taxes on oil output and income, the effect of the WPT has been to strip away about 80 cents of each additional dollar of oil company revenue due to U.S. oil price decontrol.

Even though the oil industry's tax burden is already the highest in the country, Congress is considering additional levies on oil producers. New taxes would further squeeze the sources of funds of an industry already caught between declining demand and prices, on the one hand, and rising taxes and investment spending on the other. In order to finance new taxes, oil companies would be forced further to reduce their effort to find and develop new energy supplies. Such a reduction would jeopardize the progress that has been made in recent years to reduce the world's dependence on OPEC oil.

Between 1974 and 1981, the net additions to property, plant, and equipment of the leading U.S. oil companies more than doubled. And, as Chart I illustrates, the additions were primarily for petroleum activities, especially the development of new supply in non-OPEC countries around the world. Production of crude oil has even been increased somewhat in the United States after a decade-long downward trend. U.S. oil imports are now below 5 million barrels per day, compared with a peak level of almost 9 million barrels per day in 1977. It is clear that oil companies have responded positively and successfully to the increases in oil prices and profits during the 1970's.

While oil demand has dropped sharply in recent years, and may continue to drop in the years ahead, it is dangerously premature to conclude that the oil crisis is over. As former Secretary of Energy James Schlesinger said, "I suspect the energy crisis is over until we have our next energy crisis." The success that oil companies have had in reversing the decline in U.S. oil production and diversifying oil supplies worldwide ought not to be undone through the imposition of new taxes.

B. MOVEMENT OF OIL INDUSTRY PROFITS

A widely held misconception about oil industry profits is that they move in only one direction from year to year—up. Over the long term, of course, increased profits will be earned by most industries in a growing economy—especially with inflation. (Total manufacturing profits almost quadrupled from 1960 to 1980.) However, profits rarely grow steadily year-after-year without interruption.

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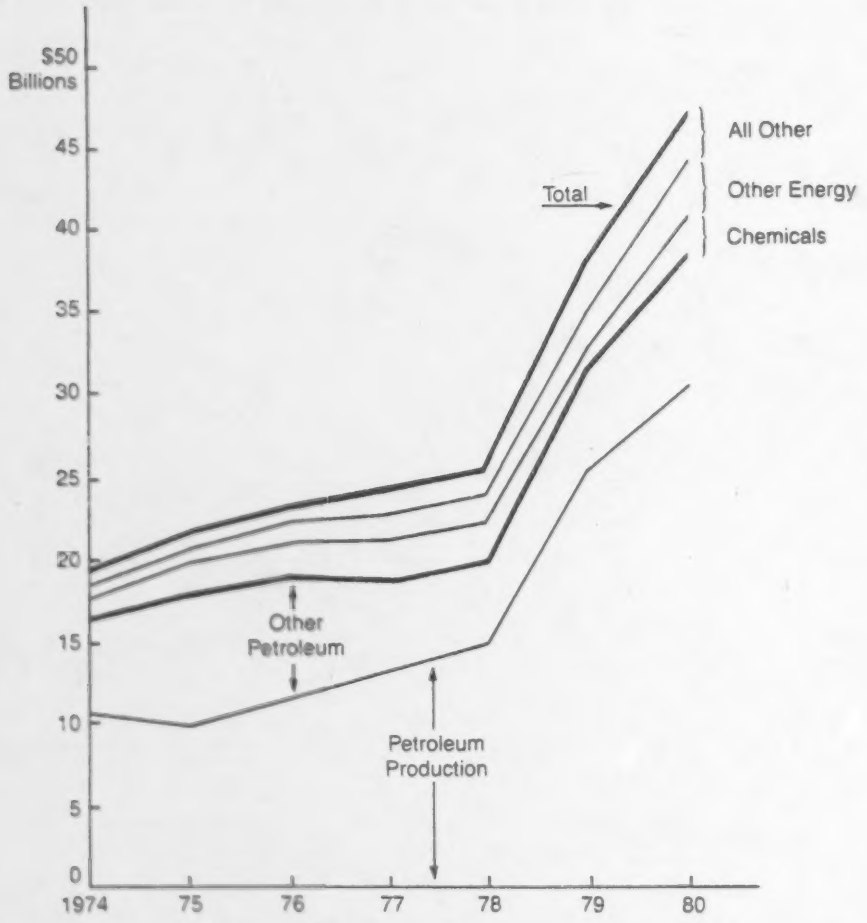
[1] The WPT properly should be considered a part of the oil industry's federal tax burden even though it is an excise tax. Inasmuch as the WPT is imposed directly on a portion of crude oil revenues, the exclusion of the tax would significantly distort the industry's tax burden relative to that of all other industries which are not subject to such a tax.

Chart I

Worldwide Additions to Property, Plant and Equipment of 26 U.S. Oil Companies



Source: Survey by Energy Information Administration, U.S. Department of Energy (See reference 1 in Appendix).

Those who seek to demonstrate continuous increases in oil profits usually select the stable years prior to the 1973–1974 market disruptions associated with the Arab oil embargo as a base period and compare this with the years immediately following the 1979 disruption associated with the Iranian revolution. such a comparison conceals the true pattern of oil profit movements over this period.

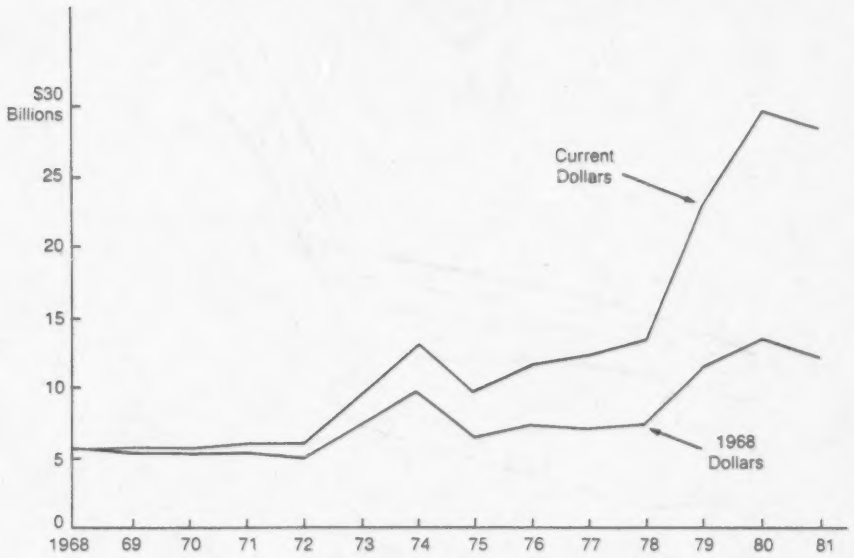
In the first place, the comparison says nothing about profitability, that is, about the relationship of profits to the amount of capital invested (see Section C below). Moreover, the comparison ignores the corrosive effects of inflation on the buying

power of the profit dollar. Finally, the beginning-to-end comparison conceals two important cycles in oil profits reflecting the 1973 and 1979 market disruptions.

Chart II shows worldwide profits of 25 leading U.S. oil companies for the period 1968–1981. Oil profits have sometimes risen and sometimes fallen, as have profits in other industries. Profits not adjusted for inflation were stable around the $6 billion level through 1972, then rose to $13 billion in 1974 but fell back to $10 billion in 1975. Thereafter, profits increased at a slow pace and only reachieved the 1974 level in 1978. Another cycle brought profits to $29 billion in 1980, followed by a decline to $28 billion in 1981 with the pace of decrease accelerating in the second half of the year. While oil profits declined in 1981, non-oil company manufacturing profits were up by about 15 percent.

Chart II

Worldwide Profits of 25 U.S. Oil Companies, 1968-1981
As Reported in Current Dollars *vs.* Buying Power
Measured in Constant 1968 Dollars*



Note: *--Deflated by the implicit price deflator for U.S. Gross National Product.

Source: American Petroleum Institute (reference 2 in Appendix).

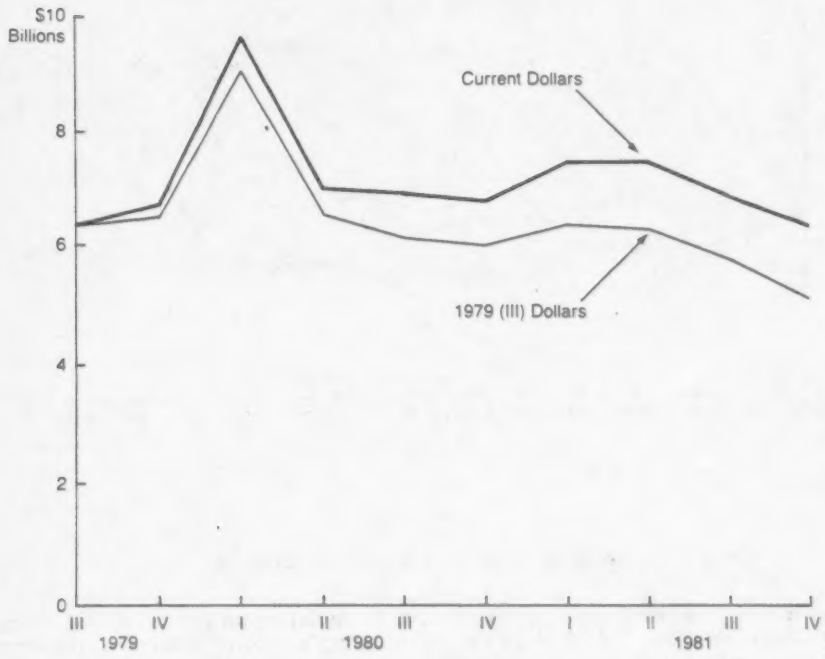
The lower line in Chart II provides a far more realistic assessment of the long-term importance of oil profits. When the real buying power of a profit dollar is considered, the 1980 profit figure of $29 billion is equivalent to $14 billion in 1968 dollars. The deflation is conservative since it is based on the implicit price deflator for U.S. Gross National Product, which has risen much less rapidly than the cost of oil exploration and production. Exploration and production expenditures account for about two thirds of petroleum capital outlays.

Recent weaknesses in oil profits reflect declining world demand for oil which has caused prices to decline and, thereby, has squeezed profit margins (see Chart III). Except for the first quarter of 1980, quarterly profits averaged about $7 billion from late 1979 to mid-1981. A drop toward $6 billion began in the third quarter of 1981.

Thus, we are observing a recurrence of the type of contraction which followed the 1973–1974 market disruption.

Chart III

Quarterly Profits of 25 Leading U.S. Oil Companies
Third Quarter 1979 to Fourth Quarter 1981
(billions of dollars)



Source: American Petroleum Institute surveys of quarterly financial reports.

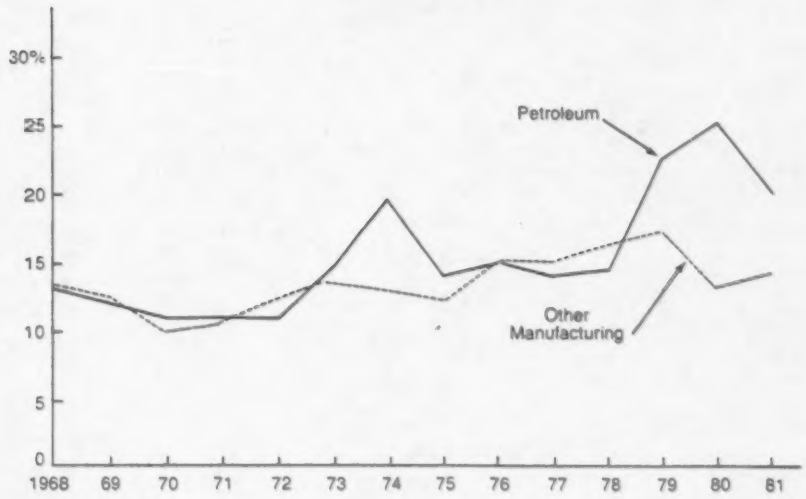
C. PROFITABILITY

The rate of return on investment is a far more significant indicator of an industry's performance than is the absolute level of profits, which ignores the level of investment. More investment creates more profits. Furthermore, return on investment is the only method of comparing one industry's profitability with another's. The most widely used measure of return on investment is net income as a percent of shareholder equity.

According to Citibank, worldwide return on equity was higher for non-oil manufacturing companies than for oil companies in three of the five years, 1968–1972—see Chart IV—despite the high degree of risk inherent in petroleum exploration. As oil prices increased in 1973 and 1974, the oil companies' rates of return rose above non-oil manufacturing—as would be expected given exploration risks. However, oil returns were again below non-oil manufacturing during 1976–1978. Thus, the oil price increases of 1973–1974 only temporarily raised oil industry profitability above other industries. For the two years 1979 and 1980, oil company returns again rose above non-oil company returns.

Chart IV

Worldwide Return on Shareholder Equity, 1968-1981
U.S. Oil Companies *vs.* Other Manufacturing
(Not Adjusted for Inflation)



Source: Survey by Citibank (see reference 3 in Appendix).

The industry, however, was struck by declining demand and prices in 1981. Consequently, there was sharp decline in the oil industry's rate of return—experienced concurrently with an increase in returns for non-oil manufacturing. By the end of 1981, the oil rate of return on historic shareholder investment was below 20 percent with no adjustment for inflation.

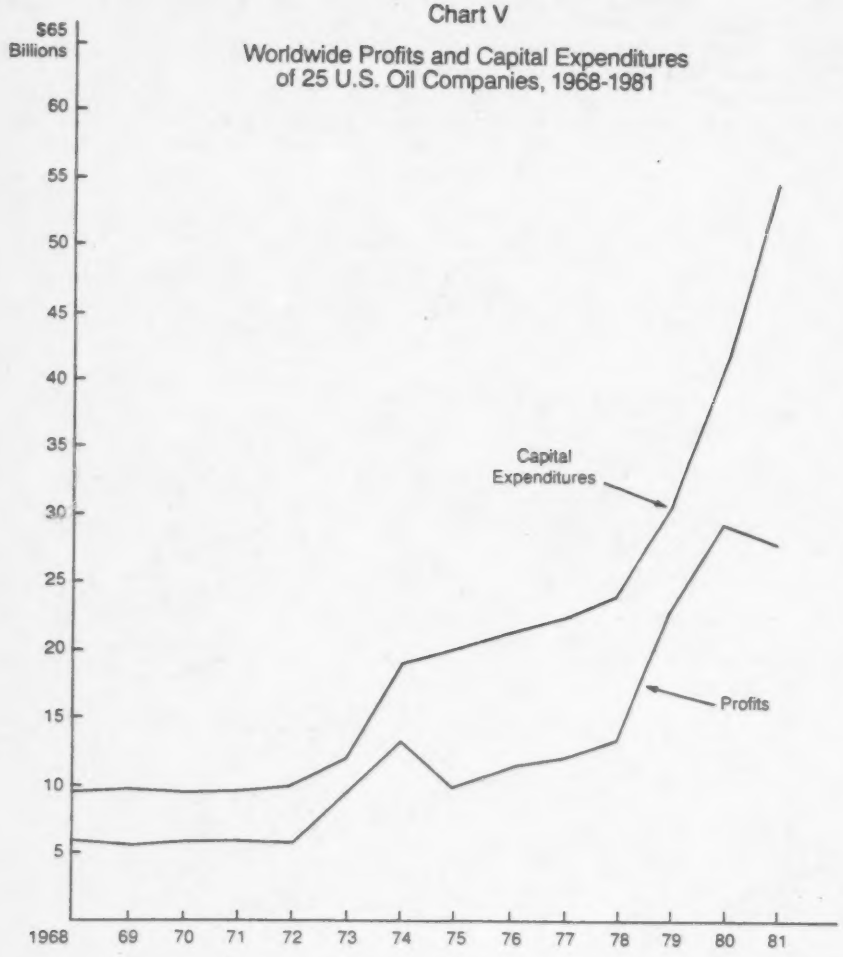
D. CAPITAL EXPENDITURES

Increased profitability has provided the incentive for substantial growth in oil industry capital spending. It has also provided much of the cash and borrowing capacity required to finance the new investments.

While profits were about constant during 1968–1972, capital expenditures were also constant. Beginning on 1974, there was a massive increase in petroleum investment reflecting higher profits—see Chart V. The average level of profits during 1974–1978 was about twice the 1968–1972 level with capital expenditures also approximately doubled:

Chart V

Worldwide Profits and Capital Expenditures of 25 U.S. Oil Companies, 1968-1981



Source: American Petroleum Institute (see reference 4, Appendix).

[In billions of dollars]

	Profits	Capital expenditures
1968–72 average	6	10
	+6	+10
1974–78 averge	12	20
	+18	+21
1980	30	41

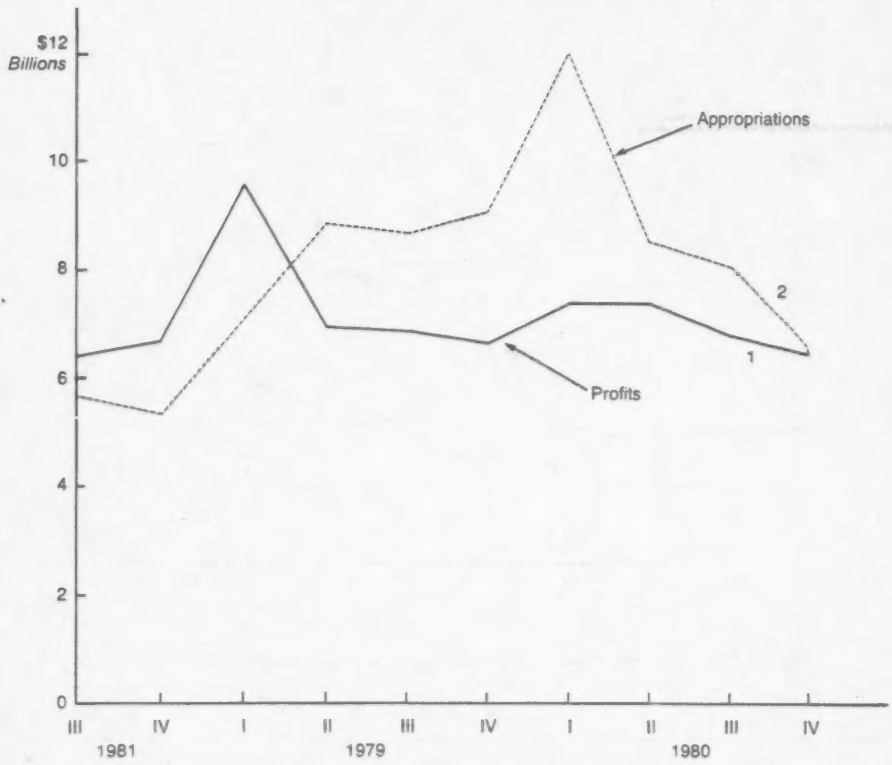
By 1980, profits were up by another $18 billion and capital expenditures were up by $21 billion. The larger absolute increases in capital expenditures were financed by increased borrowing made possible by rising profits.

During the first nine months of 1981, capital expenditures rose sharply despite the leveling off and, then decline in profits.

However, reductions in investment lag behind decreases in profits because of commitments already made. Current surveys show planned reductions in 1982 expenditures as the long-term correlation between profits and investment takes hold.

Chart VI

Quarterly Profits of 25 Leading U.S. Oil Companies
Compared with New Capital Appropriations
Third Quarter 1979 to Fourth Quarter 1981
(billions of dollars)



Source: American Petroleum Institute (profits) and the Conference Board (new capital appropriations).

Chart VI depicts the closer relationship between oil company profits and appropriations for capital spending. While movements in appropriations still trail movements in profits, the period of adjustment is shorter. Thus, the latest fourth quarter 1981 data on new capital appropriations ($6.6 billion) are 20 percent below third quarter appropriations ($8.2 billion) and almost 50 percent beneath the peak first quarter level ($12.1 billion). Clearly, the combination of declining prices, decreasing profits, and rising taxes is taking its toll on the pace of investment spending by oil companies.

The House Democratic Study Group (DSG) recently asserted that leading oil companies "seemed to be pursuing a strategy of hoarding a large share of the cash flow which decontrol brought them instead of investing it in energy." The DSG contended that only 44 percent of the leading companies' increased funds during 1978–1980 were invested in petroleum projects. This allegation is both misleading and incorrect.

One might suppose that the DSG's 44 percent figure refers to petroleum investment as a share of all capital investments, but this could not be correct. As was shown in Chart I above, leading oil companies added $88 billion of petroleum assets from 1978–80 out of a total addition of $110 billion—about 80 percent. Of the other $22 billion, about $7 billion was spent on chemical facilities (a long-standing extension of petroleum refining), $6 billion on other energy sources, and $9 billion on other businesses. Over the longer period 1974–1980, additions in the "other" category averaged only about 6 percent of the total.

Of course, capital expenditures are not the only appropriate use of corporate funds. Dividends must be paid to shareholders. Debt must be repaid. And inventories, receivables and working cash balances must grow with the growth of a company's business. Uses of funds by 25 large companies during 1978–1980 were as follows:[1]

	Amount (billions)	Percent of total
Capital expenditures	$96	67
Investments and advances	17	12
Dividends	21	15
Additions to working capital	6	4
Other	3	2
Total	143	100

The alleged "hoarding" of funds amounted to an addition to working capital of only $6 billion—4 percent of total uses of funds—in a period when the dollar volume of business skyrocketed as OPEC raised oil prices and shortened credit periods. (During these years, sales revenues rose by three fourths while working capital rose by only one third.) Capital expenditures were about two thirds of the total—dividends a sixth.

By comparison with other industries, Department of Energy data for 1978–1980 show that 374 non-oil industrial companies used 56 percent of their funds for additions to property, plant, and equipment—well below the 67 percent shown above for the capital expenditures of leading petroleum companies. During this period, non-oil companies also paid out a higher share of their funds for dividends. It is clear that the petroleum industry responded promptly and strongly to the dual effects of improved profitability: increased incentive to invest and increased funds to carry out new projects.

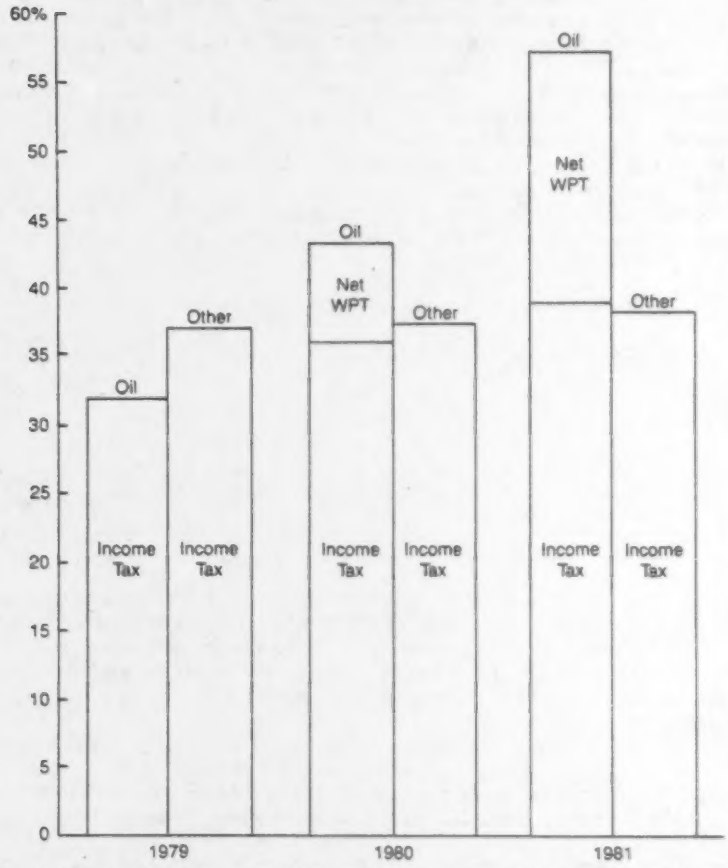
E. TAX BURDEN

Private investment, responding to relative rates of return, is the most effective method of allocating capital resources throughout the economy. Interference with this process diminishes the economy's efficiency. Thus, taxing petroleum even more, relative to other industries, would discourage investment just as the country is making encouraging progress in the quest for energy security.

[1] American Petroleum Institute "Key Financial Data of Leading U.S. Oil Companies, 1968–80," Discussion Paper #017R, October 28, 1981, Table III. Data are tabulated from Annual Report and 10-K's. "Investment and Advances" also include increases in long-term receivables and acquisitions of existing firms.

Chart VII

Current Domestic Tax Burden of U.S. Oil Companies
Compared with Other Companies, 1979-1981
(Income and Windfall Profit Tax as
Percentage of Income Before Tax)*



Note: *--Oil income taxes shown for 1980 and 1981 are what would have been paid without the Windfall Profit Tax, which is shown net of the income tax offset. In the WPT computational procedure, the WPT is deducted from income; and income tax is levied on the residual. If there were no WPT, the income tax would be higher--as shown above.

Chart VII compares the partial tax burden of the U.S. oil industry and other U.S. companies for 1979, 1980, and 1981. Taxes included are current U.S. federal and state income taxes and the crude oil Windfall Profit Tax. For 1981, petroleum income tax burden alone is comparable to that of other companies—roughly 38 percent. However, the WPT has created a dramatic disparity in tax burden—roughly 57 percent vs. 38 percent. Moreover, the data exclude state severance taxes and "deferred" income taxes (which arise primarily from the difference between accelerated and economic-life cost recovery). These deferred income taxes are highest for industries, such as petroleum, which are investing heavily in new plant and equipment.

II. The Administration's Proposed Corporate Minimum Tax

A. IN GENERAL

The Administration has proposed an alternative Corporate Minimum Tax (CMT) to replace the existing 15 percent add-on corporate minimum tax. The existing tax is equal to 15 percent of certain so-called "preference items" in excess of the greater of $10,000 or 100 percent of a corporation's regular federal income tax liability for the year. For most corporations, this means the existing minimum tax is payable only when the total preference items exceed the regular federal income tax liability for the year.

Under the current law, no distinction is made in the treatment of preferences resulting from permanent reductions in effective tax rates versus those resulting from mere timing differences in cost recovery. The corporate preference items which result in permanent tax reductions are (1) percentage depletion in excess of the adjusted basis of the property and (2) 18/46 of long-term capital gains. Corporate preference items under existing law which represent mere timing differences are (1) deductions by financial institutions for bad debts in excess of the amount that would have been allowed on the basis of actual experience, (2) the excess of Accelerated Cost Recovery System (ACRS) deductions over 15-year straight-line recovery for real property, (3) the excess of 5-year amortization of certified pollution control facilities over ACRS deductions, (4) the excess of 5-year amortization of railroad rolling stock over 10-year ACRS deductions, and (5) the excess of 5-year amortization of child care facilities over ACRS deductions.

In addition to preferences similar to the above corporate items, the list of preferences for individuals includes (1) the deduction for intangible drilling and development costs (ICDs) to the extent such deduction exceeds the first year deduction, if any, under 120-month straight-line amortization, less oil and gas net income, and (2) the excess of ACRS deductions over straight-line recovery for certain leased property.

The Administration's new proposed CMT would be computed on taxable income (including capital gains), exclusive of any net operating loss carryovers, plus the sum of the existing corporate preference items (except the railroad rolling stock and 18/46 of corporate long-term capital gains preferences), and the sum of a number of new preference items. The new preference items are:

1. The excess of IDCs incurred during the year over a first year amount of 120-month straight-line amortization, with no reduction for existing oil and gas net income (as is available to individuals) and no straight-line amortization after the first year.
2. The excess of mining exploration and development cost deductions over a first year amount of 120-month straight-line amortization, with no reduction for existing income from mining and no straight-line amortization after the first year.
3. The excess of lessor tax deductions under the safe-harbor leasing provisions of ACRS over straight-line amortization over the lease term of net cash invested by the lessor.
4. Deductions for interest on indebtedness to purchase or carry tax exempt securities.
5. Deferred Domestic International Sales Corporation (DISC) income.
6. Shipping income deferred through amounts deposited in construction reserve funds or capital construction funds under the Merchant Marine Act.
7. Amortization of motor carrier operating rights.
8. The excess of interest deducted on original issue discount bonds over the amount that would have been deductible if the interest were computed on an actuarial basis at the interest rate equal to the yield at which the bond was issued.
9. The excess of deductions allowed for certain indirect costs incurred for long-term contracts entered into before February 26, 1982, over the amount that would be allowed under the proposed new progress-paymernt method of accounting rules.

The Administration's proposal would erect a barrier to new investment for those taxpayers which may be placed in a minimum tax position due to depressed earnings or a substantial investment program. For such taxpayers, the current after-tax cost for each dollar of incremental investment would increase from $.54 under present law to $.85 for non-preference expenditures and to $1.00 for preference items. In effect, the taxpayer would be denied any tax deduction for incremental expenditures or investments which are preference items. See Exhibit A.

A major defect in the proposed CMT is its failure to allow the corporation a deduction to recover a significant part of the cost of the "preference" in calculating the tax. Obviously, if no deduction is allowed for substantial costs incurred in earning income, the amount of the income and the tax thereon is artificially inflated. That is precisely what the CMT does, and the taxpayer may be in a worse positon than if it had not been permitted (or required) to claim an accelerated deduction. If the corporation had never been granted the so-called "preference" but had been required to deduct the preference over any reasonable period such as under the new ACRS, no CMT would be due in most instances. Thus it is obvious that the CMT would tax recovery of capital as well as economic income. See Exhibit B, Part I.

The Administration's proposed CMT would also not allow the investment tax credit (ITC) to be used as a credit against the CMT. Thus, as long as a taxpayer remains subject to the CMT, all current benefit of the ITC would be lost on incremental investment. This, like the loss of full cost recovery, would frustrate the goals under the Economic Recovery Tax Act of 1981 (ERTA) to encourage new business investment in plant and machinery, and would slow or even preclude recovery in many depressed industries.

A special CMT credit measured by the excess of CMT over regular tax would be applied against the regular tax in subsequent years. However, this CMT credit appears to provide no relief so long as a taxpayer remains in a CMT position. Moreover, no provision is made for reflecting the excess of regular tax over CMT to take into account fluctuations in income or timing of preferences. Finally, the Technical Explanation does not mention a "tax benefit rule" similar to that afforded individuals (see I.R.C., Sec. 56(b)) or other provisions usually associated with existing timing preference items.

Passage of the new corporate minimum tax would be a step backward from the goal of administrative simplicity. Two alternative tax systems will affect the corporation's investment decisions. The consequences of an investment decision would have to be reviewed with respect to the two taxes simultaneously. This type of "two-track" analysis would impose additional uncertainty and complexity under the Administration's accelerated estimated tax proposal as well. Further, a non-deductible penalty (as opposed to a deductible interest charge) on underpayments would force taxpayers to overpay their estimated tax liability.

The CMT proposal does provide for a foreign tax credit (FTC) subject to limitations as the only available credit against the CMT. This FTC is based upon a recognition of international tax principles designed to eliminate double taxation among countries as well as possible problems with existing tax treaties if such credit were not provided.

The FTC does not address those taxpayers deducting foreign taxes in computing regular taxable income or incurring "overall foreign losses" as a result of recent entry into foreign operations or heavy foreign exploration and development programs. Apparently, no provision is made to eliminate CMT on foreign preferences generated solely by reason of recapture or overall foreign losses incurred prior to the effective date of CMT, or to allow a separate election to deduct or credit foreign income taxes in computing CMT.

B. INTANGIBLE DRILLING AND DEVELOPMENT COSTS

Background

Over the past years, a significant amount of attention has been directed to the current deduction of "intangible drilling and development costs." Despite this previous consideration, the history, nature and impact of the option to deduct such costs is sometimes overlooked. Inasmuch as the Administration's minimum tax proposals could adversely affect the economic viability of oil and gas drilling operations, we believe that it is important to reexamine briefly the nature and tax treatment of intangible drilling and development costs as a predicate to our comments in opposition to the proposal.

Under the Treasury Regulations, an IDC is any cost incurred that in itself has no salvage value and that is "incidental to and necessary for the drilling of wells and

the preparation of wells for the production of oil and gas."[1] (Treas. Reg. Sec. 1.612-4) Such costs expressly include wages, fuel, repairs, hauling, supplies, etc., which are incurred in the drilling of wells, in the clearing of ground, and in the construction of derricks, tanks and other physical structures that are necessary for the drilling of wells and the preparation of wells for the production of oil and gas.

For income tax purposes, IDCs are capital in nature and, as such, would ordinarily be taken into account through allowances for cost recovery. Section 263(c) of the Internal Revenue Code, however, provides an exception to this general rule whereby the taxpayer has the option to deduct such costs currently. Under the option, only the holder of a "working" or an "operating" interest (i.e. the interest which is burdened with the risks and costs of developing and operating the property) may currently deduct IDCs. Moreover, the election to deduct IDCs must be made by the taxpayer for the first taxable year in which such costs are incurred and is binding for all subsequent years.

The option to deduct IDCs for income tax purposes is not of recent origin. Although no specific statutory authority existed for the deduction of IDCs until 1954, the election was first made available by administrative ruling in connection with the Revenue Act of 1916. T.D. 2447, issued February 8, 1917, reads as follows: "The incidental expenses of drilling wells, that is, such expenses as are paid for wages, fuel, repairs, etc., which do not necessarily enter into and form a part of the capital invested or property account, may, at the option of the individual or corporation owning and operating the property, be charged to property account subject to depreciation or be deducted from gross income as an operating expense."

Initially, the tax treatment of IDCs was influenced by the fact that many taxpayers considered the expensing of such costs to be an acceptable accounting practice. The treatment was also justified as a means of encouraging the exploration and development of our Nation's natural resources. Although accounting practices may have changed over the years, the policy to develop our Nation's mineral resources still supports the need for rapid recovery of IDCs for tax purposes. The element of high risk is still present inasmuch as oil and gas deposits have become even more difficult to find. Additionally, the costs of drilling have escalated in response to greater logistical and technological problems which are encountered today as the industry drills in more hostile offshore and frontier environments.

IDC's as an item of "Tax Preference"

Under present law, the amount by which the "excess IDC's" exceed the net income from oil and gas properties during the year is a so-called "tax preference" item for individuals. (I.R.C. Sec. 57(a)(11) "Excess IDC's" are deductible IDC's (other than dry hole costs) incurred during the taxable year less the amount, if any, that would have been deductible in the same year if the taxpayer has amortized the expenses for that year over 120 months beginning with the month of first production (or, if the taxpayer so elects, less the amount of cost depletion that would have been deductible rather than the 120-month amortization). Since only the first year's allowance for cost recovery is recognized for minimum tax purposes, the amount of the IDC preference is substantially overstated. The IDC tax reference under current law, however, does not apply to corporations.

IDC's first became an item of tax preference in 1976 as part of a major legislative attack on "tax shelters". The efforts of Congress were directed, however, to individual "tax shelter" investors and not to corporations or to individuals in the business of exploring for and developing oil and gas. This intent was clearly demonstrated when the offset for net income from oil and gas properties was added by the Tax Reduction and Simplification Act of 1977 (P.L. 95-30) and the Revenue Act of 1978 (P.L. 95-600). The offset was considered necessary because the 1976 rules penalized individuals in the business of exploring for oil and gas. Moreover, Congress was concerned that without the net income offset, seriouis economic distortions could result especially with regard to marginal wells. The following example which was inserted in the Congressional Record by Senator Bentsen, one of the sponsors of the modification, demonstrates the intent of Congress that the minimum tax on IDC's was not intended to penalize producers.

Example: An independent producer, with substantial oil and gas income, had spent $350,000 in IDC's drilling a well. It would have cost $85,000 to complete the well. The producer estimated a net income of $2,000 a month from the well and would have completed it, expecting a payout of the completion costs in 41 months and a profit (if IDC's are ignored) over the eight-year life of the well. But *the mini-*

[1] For simplicity purposes, our comments are made with specific reference to oil and gas IDCs. Our views also are intended to encompass geothermal IDCs.

mum tax on IDC's totally changed the picture because a minimum tax of 15 percent of the IDC's ($52,500) would be due. Because the minimum tax isn't deductible in computing the producer's income tax liability under Section 1, he would pay $52,500 from after-tax income, which would require pre-tax profits of $175,000 from the well. *On those assumptions, the well couldn't make a profit and was plugged as a dry hole.* (123 Cong. Rec. Page S6702 daily ed. April 28, 1977; Emphasis Added)

Administration's proposal on IDC's

Under the Administration's proposal, IDC's (other than dry hole costs) would become a tax preference item subject to the proposed alternative minimum tax for corporations. The IDC tax preference amount would equal the deduction of IDC's for the taxable year in excess of the amount allowable in the year incurred, if such costs had been capitalized and amortized on a straight line basis over 120 months beginning with the month of first production. If there is no production during that year, no offset for cost recovery is ever allowed. Unlike the IDC preference item rules for individuals, there is no offset for the net income oil and gas properties.

The treatment of IDC's as a preference item under the Administration's corporate minimum tax proposals is unwarranted and counterproductive for the following reasons:

(1) *The Treatment Of IDC's Does Not Constitute A Tax Preference When Compared To The Treatment Afforded Other Capital Costs Under ACRS.*—In determining whether an item of deduction properly constitutes a "tax preference", the tax treatment afforded the item subject to scrutiny should be compared to the tax treatment afforded essentially similar items which do not constitute items of tax preference. In the case of a timing preference item, the item under scrutiny may properly be considered a tax preference only if the tax treatment afforded such item significantly reduces the present value of the taxpayer's after-tax costs when compared to the treatment afforded non-preference items. Thus, the tax treatment of IDC's should not be considered a tax preference.

Treatment of IDC's as a preference fails to recognize that on a present value basis, current expensing of capital costs is not appreciably different from recovery under the ACRS for 5-year property plus the 10 percent ITC. Comparing the tax treatment of IDC's to that of depreciable property under ACRS is consistent with the views of Congress previously expressed regarding capital cost recovery (see (2) below) and is conceptually proper under recognized tax accounting principles notwithstanding Treas. Reg. Sec. 1.612-4(b)).*

For example, similar types of costs (i.e. wages, fuel, repairs, hauling, supplies, etc.) which are capital in nature and which are associated with the construction of assets which fall outside the parameters of the IDC option would be considered depreciable property eligible for ACRS (e.g. the costs of drilling a water source well to be used solely for secondary recovery operations). Moreover, such costs are capitalized and recovered along with related tangible costs through allowances for depreciation under generally accepted accounting principles for financial statement purposes. (See Financial Accounting Standards No. 19, p. 13.) Accordingly, in determining whether IDC should be considered a preference item, the present value after-tax cost of current deduction should be measured against 5-year ACRS plus 10 percent ITC. Under this type of analysis, it becomes clear that the current expensing of IDCs subject to the CMT is less favorable than ACRS or even the earlier 11-year ADR depreciation schedule for oil and gas production equipment, plus the 10 percent ITC. The following table illustrates this point:

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* The current treatment of capitalized IDC as a depletable investment under Treas. Reg. Sec. 1.612-4(b) is not based on sound tax accounting theory, but on a questionable IRS interpretation of the discovery value depletion provisions of the Revenue Act of 1918. IDC's were originally treated as depreciable investment if the taxpayer did not elect to deduct them currently. (T.D. 2447, February 8, 1917.) With the advent of discovery value depletion in 1918, the IRS changed its position and contended that the depletable value of the well included capitalized IDC's except to the extent they were represented by physical property which was still considered depreciable. (Regulations 45, Art. 223.) The IRS continued to take the same position after percentage depletion was substituted for discovery value depletion in 1926. (Treas. Reg. Sec. 1.612-4(b)—current regulations.) With repeal of percentage depletion on most production, there clearly is no basis for continuing to characterize any portion of IDC's as depletable investment.

TABLE 1.—PRESENT VALUE AFTER TAX COST OF $1,000 OF INTANGIBLE DRILLING AND DEVELOPMENT COSTS (IDC) AT A 15-PERCENT DISCOUNT RATE

	Expenditure	Current year deduction	Effect on Federal income tax at 46 percent	Cost after Federal income tax	Present value after tax cost at 15 percent discount
Current law—Corporations	$1,000	$1,000	$460	$540	$540
5-year ACRS ($1,000 expenditure):					
ITC			100		(100)
Year 1		150	69		(69)
Year 2		220	101		(88)
Year 3		210	97		(73)
Year 4		210	97		(64)
Year 5		210	96		(55)
Total		1,000	560	440	551
11-year ADR DDB/SYD with ITC	1,000	(1)	560	440	610
IDC-current deduction subject to CMT	1,000	1,000	2 0	1,000	1,000

[1] Detail of depreciation deductions not shown for purposes of simplicity.
[2] Recognizes that the 120-month amortization offset would not be available if production commences in subsequent year, which is usually the case.

(2) *To Treat IDC's As An Item Of Tax Preference Is Inconsistent With The Stated Views Of Congress Concerning Capital Cost Recovery.*—The imposition of a minimum tax on IDC's effectively erodes the ability of taxpayers to recover capital costs and is inconsistent with the conclusions reached by Congress during its consideration and adoption of the Economic Recovery Tax Act of 1981 (P.L. 97-34, H.R. 4242). Indeed, the key issue in the debate on H.R. 4242 relating to the need for an improved capital cost recovery system was whether the cost of most machinery and equipment should be expensed instead of recovered over five years with a 10 percent ITC.

The report of the Committee on Ways and Means on its version of H.R. 4242 explained the advantages of current expensing over deferred cost recovery as follows:

"Deductions spread over a term of years are eroded by inflation, reducing their real value, the profitability of investment and hence the incentive to invest. This tax reduction program should provide for expensing. This simple depreciation rule gives the maximum acceleration of depreciation deductions, insulates these deductions from the adverse effects of inflation and eliminates tax incentives to make inferior investments." (H. Rpt. 97-201, at page 17, H.R. 4242)

Although Congress ultimately choe the 5-year ACRS, current expensing was clearly accepted for most equipment as a standard against which any capital recovery system should be measured.

During its deliberations of H.R. 4242, the Congress reviewed the existing treatment of IDC expenditures and declined to make any changes in present law. Thus, the retention of the option to deduct currently the IDC portion of the cost of an oil or gas well (without a minimum tax) is supported by recent Congressional action and the statement in the Report of the Committee on Ways and Means on H.R. 4242 as quoted above.

The current deductibility of IDC's embodies this standard for tax efficiency and neutrality. The real value of expenditures on intangible drilling and development is not eroded by inflation. Deducting IDC's does not eliminate any tax liability for oil and gas producers, nor does it impose any long-range reduction in federal tax receipts. Moreover, existing law provides for the "recapture" of certain IDC expenditures as ordinary income where taxpayers make early disposition of oil and gas properties at a gain. Therefore, the current deduction of IDC is approximately the same as recovery under ACRS with the 10 percent ITC. Hence, there is no economic justification for penalizing producers through the imposition of a minimum tax on IDC's.

(3) *To Treat IDC's As An Item Of Tax Preference May Result In Economic Distortions Not In Furtherance Of The Nation's Energy Policy.*—The search for new oil and gas reserves entails high-risk, capital intensive operations. The right to deduct IDC expenditures is important to the national effort to find and develop increased domestic petroleum supplies. Diluting this deduction through the imposition of a minimum tax would hamper the search for new oil and gas reserves. Once becoming subject to CMT, a taxpayer is effectively denied any current tax deduction for addi-

tional investment in IDC's. The CMT also increases the cost of completing a well by 15 percent of the IDC's, as compared to plugging it as a dry hole. These additional after-tax costs would substantially curtail additional drilling, preclude completion of many marginal wells, and reduce available reserves and production particularly with respect to high risk exploratory prospects. (See exhibit B, Part II.)

In most cases, oil companies are in a cash-limited position; that is, the amount of funds required to carry out their capital investment programs exceeds the amount of funds generated through operations and borrowings. Consequently, oil companies are required to operate within certain budget constraints in undertaking new drilling programs and other projects. The number of new wells which can be drilled, for example, is determined by the amount of funds available after taking into account federal and other taxes. For those companies subject to the CMT, less funds will be available and, consequently fewer wells can be drilled, to the extent that expenditures give rise to increased taxes (i.e. CMT).

(4) *The Administration Proposal Pertaining To IDC's As An Item Of Tax Preference Contains Numerous Defects And Omissions.—*

(a) Failure to provide an offset for net income from oil and gas properties similar to that provided to non-corporate taxpayers would impose a tax penalty on completing oil and gas wells and would reduce oil and gas drilling efforts. The failure to include an offset mechanism is inconsistent with the legislative actions taken by Congress in 1977 and 1978 as explained earlier in our comments. Such an omission constitutes a penalty on corporate producers engaged in oil and gas exploration and development and is contrary to the Nation's energy goals.

(b) The Administration's proposal fails to provide taxpayers with an opportunity to forego the IDC tax deductions and, through a property-by-property election, treat IDC's as 5-year recovery property under ACRS eligible for ITC. As a result, the proposal is not consistent with the elections accorded taxpayers on other existing with the elections.

(c) As with other timing preferences, no allowance is made for cost recovery beyond the first year in calculating the amount of the IDC preference. Additionally, corporate taxpayers apparently would not be entitled to use the "tax benefit rule" currently available to non-corporate taxpayers.

Conclusion

The inclusion of IDC's as an item of tax preference subject to minimum tax would sacrifice important long-range economic and energy security goals. To the extent that IDC expenditures are reduced, discoveries of new reserves and enhanced production efforts in existing fields would decline, and in the long term, profits and tax revenues would decrease. Moreover, there is no sound conceptual basis for treating IDC's as a tax "preference."

C. PERCENTAGE DEPLETION

The excess of allowable percentage depletion over the adjusted basis of the property at year end would also be included as a preference item under the CMT. As under the exisitng minimum tax for corporations, the measure of the so-called tax preference for percentage depletion fails to recognize the impact of inflation on the recovery of depletable costs incurred in locating and acquiring oil and gas properties. Measured against current expensing and ACRS (plus ITC), cost depletion falls far short of providing adequate recovery of real costs or recognition of replacement costs. As a result, the nominal profits of oil and gas producers are substantially overstated and taxation of "phantom" income is inevitable.

To the extent it is still available to independent producers, percentage depletion based on wellhead prices of crude oil tends to mitigate this problem somewhat by reflecting more nearly the current replacement cost of existing oil reserves and moving closer to an accurate measure of real net income to the producer. Therefore, the inclusion of percentage depletion as a tax preference is unwarranted and inappropriate.

D. FOREIGN OPERATIONS UNDER THE PROPOSED MINIMUM TAX

Background

In light of the adverse competitive effect of international double taxation, the foreign tax credit has remained in the United States tax law and has been accepted as a basic international principle in tax treaties and tax laws of most developed countries. As with any tax provision, there have been changing notions embodied in various Federal revenue acts as to the mechanics for calculating the foreign tax credit; but the basic principle has always been retained that United States taxpayers

should not be double-taxed by the United States on foreign-source income to the extent such income has already been taxed by the country in which the income is earned. If the United States were to deviate from this principle and attempt to impose an additional tax of foreign income, it would make U.S.-based companies non-competitive in the international business sector. The avoidance of international double taxation and the continuance of international competitiveness are traditional principles that must be preserved.

Administrative proposal

The Treasury Department's technical explanation describes the tax base upon which the proposed CMT for the taxable year would be calculated as the sum of "regular" worldwide taxable income (excluding net operating loss carrybacks and carryovers) plus the worldwide items of tax preference. After applying the CMT rate to this base, no credit is allowed other than a foreign tax credit (FTC) subject to limitations. The allowable FTC is computed separately under a limitation formula expressed as:

Foreign source CMT base divided by worldwide CMT base times CMT equals maximum allowable FTC.

Additionally, for petroleum industry taxpayers, further limitations regarding foreign tax credit with respect to foreign oil and gas extraction income, foreign oil related income, and other foreign taxable income are applicable with reference to the respective foreign and worldwide CMT bases; and the CMT rate is applied instead of the regular U.S. income tax rate. No carryover or carryback of any excess FTC against CMT would be allowed. The effect of this formula is to limit the maximum amount of creditable foreign taxes to tha portion of the CMT attributable to only the foreign-source CMT base.

If for a taxable year a taxpayer reaches the position of having sufficient creditable foreign taxes to offset U.S. tax on foreign source income and preferences, the FTC under the Administration's proposal appears to safeguard against further international double taxation. However, anything less than a credit for foreign taxes against CMT (for example, allowing only a deduction of foreign taxes in calculating CMT) creates multiple taxation of foreign operations and renders the U.S.-based taxpayer non-competitive. Notwithstanding the FTC provision, there are taxpayers whose foreign operations would be penalized by the proposed CMT, even though they may be incurring significant foreign income taxes.

CMT penalties

(1) *Acceleration of U.S. Tax on Foreign Operations Renders U.S. Companies Non-Competitive.*—In bidding against non-U.S. companies for foreign operations, U.S.-based companies must be competitive while realizing an acceptable rate of return on investment. When significant investment places a taxpayer in an overall foreign loss position, CMT taxes preference expenditures even though the taxpayer may be incurring substantial foreign income taxes. Thus, CMT potentially imposes an additional cost on foreign operations which foreign competitors would not incur.

As indicated in Exhibit C, the U.S. taxpayer theoretically could pay the same total U.S. tax on foreign operations over a period of several years. However, acceleration of current U.S. tax payments under CMT, when netted against the present value of future U.S. tax reductions, if any, creates a current additional cost.

The inability to use FTC carryover or carryback againt CMT would also place an additional burden on foreign operations.

If the taxpayer must cover the additional U.S. tax cost to realize a minimally acceptable rate of return, it can expect to lost the bid to another company not having such additional cost. Thus, such cost could render the taxpayer non-competitive in foreign operations.

(2) *CMT Penalizes Taxpayers for Section 904(f) Recapture of Prior Overall Foreign Losses.*—Generally, an "overall foreign loss" occurs when gross income from foreign sources is exceeded by the sum of the deductions properly apportioned or allocated to such income. When such a loss initially offsets U.S.-source income, it is subject to "recapture" in subsequent years. The recapture of such loss is accomplished by treating all or a portion of future foreign-source taxable income (up to an amount equal to the cumulative total of overall foreign losses in prior years) as income from U.S. sources. This is usually achieved in one of two ways once the taxpayer moves to an overall foreign income position:

(a) The taxpayer may continue to elect to deduct foreign taxes paid or incurred on such foreign profits, and to pay U.S. income tax on the taxable income. Such income offsets the prior accumulated foreign losses. After fully offsetting such losses, the taxpayer would ordinarily then elect to credit foreign taxes against U.S. income tax, thereby eliminating subsequent double taxation of such foreign-source income; or

(b) The taxpayer immediately elects to claim foreign taxes paid or accrued as a credit against U.S. income tax on such foreign profits, in which event the lesser amount of the accumulated foreign losses or at least 50 percent of foreign income (100 percent in the case of certain dispositions) is treated as U.S.-source income subject to U.S. income tax without benefit of the elected foreign tax credit until such losses are fully recaptured.

Regardless of which of the above methods is employed, the Administration's proposal would appear to levy a CMT on the recapture of overall foreign losses incurred prior to the effective date of CMT. Thus, for those taxpayers who continue to recapture pre-CMT overall foreign losses under method (a) above, the absence of an election either to deduct or credit foreign income taxes for CMT purposes results in CMT on the total CMT base with no offsetting FTC. Likewise, those taxpayers recapturing overall foreign losses via the foreign tax credit mechanism under method (b) above would be subject to CMT on pre-CMT losses should Section 904(f) recapture rules be applied to the CMT base.

Payment of CMT solelyh by reason of recapture of pre-CMT foreign losses places the taxpayer in a non-competitive position.

Conclusion

The introduction of CMT under the Administration's proposal raises serious tax as well as national energy, security, fiscal, and other policy concerns. As described above, when CMT operates to subject U.S.-based companies to international double taxation on foreign operations, such taxpayers cannot compete with companies whose incomes are taxed only once. Accordingly, the resulting double taxation would preclude U.S.-based companies from expanding foreign operations and would force their withdrawal from existing foreign operations.

With particular reference to the U.S. energy situation, U.S. needs for foreign supplies of crude oil will continue for the foreseeable future. If U.S.-based petroleum companies are economically barred from foreign crude oil exploration and production, this country would become dependent not merely upon foreign supplies but upon foreign suppliers. The inability of U.S.-based petroleum companies to enter into, continue, and expand foreign petroleum operations due to non-competitive costs would likely result in significant reduction of world crude oil production and reserves, creating higher market costs for energy in the United States, affecting U.S. exports adversely, and impairing the U.S. balance-of-payments position.

CONCLUSION

Overall, the CMT, like its predecessors, is a poorly conceived attempt to raise additional revenue under the guise of fairness. In effect, it is a tax on corporate investment, and in many instances will tax "beneficiaries" of tax preferences at rates higher than if no preference existed. The impact of the CMT is counterproductive to the investment goals contained in ERTA to spur business expansion, strengthen U.S. job opportunities and increase exports.

EXHIBIT A

INVESTMENT—AND EMPLOYMENT—DISCOURAGING EFFECTS OF THE ADMINISTRATION'S MINIMUM TAX PROPOSAL

I. Base case

Assume that a corporation has taxable income of $2,000. Under present law, its regular income tax would be $920: [1] $2,000 times 46 percent equals $920.

The Administration's Corporate Minimum Tax proposal (CMT) would calculate an alternative tax, with the tax payable to be the higher of the regular or alternative tax. Assume that the corporation has $3,000 of tax "preferences." The tentative alternative tax would equal the sum of taxable income and preferences multiplied by 15 percent: $2,000 plus $3,000 equals $5,000; or $5,000 times 15 percent equals $750.

Since the CMT of $750 would be less than the regular tax of $920, the regualr tax would apply.

II. Base case plus IDC's of $370

Assume now that the corporation invests $370 in intangible development costs (IDCs), a proposed preference item, with no income from the well until the second year. (IDCs include drilling costs for items having no salvage value, e.g., the drilling

[1] We ignore rates less than 46 percent on smaller amounts of income.

contract fee.) Since IDCs are expensed under present law, the regular tax would fall to $750: $2,000 minus $370 equals $1,630; or $1,630 times 46 percent equals $750. That is a decrease of $170; $920 minus $750 equals $170.

Since the new IDC outlay is $370, it would reduce the regular tax liability by 46 cents on the dollar: $170 divided by $370 equals $0.46.

Looked at the other way, the after-tax cost of the IDCs would be 54 cents on the dollar: $1.00 minus $0.46 equals $0.54.

With the IDC outlay of $370, the tentative CMT calculation would lead to the same result as the regular tax: $1,630 plus $3,000 plus $370 equals $5,000; or $5,000 times 15 percent equals $750.

Hence, the tax payable would be the same under either method: $750.

III. Base case plus IDC's of $370 plus another $500 of IDC's

Assume now that the corporation invests another $500 in IDCs. Taxable income and the regular tax would decline: $1,630 minus $500 equals $1,130; or $1,130 times 46 percent equals $520.

In contrast, the CMT would remain the same: $1,130 plus $370 plus $500 plus $3,000 equals $5,000; or $5,000 times 15 percent equals $750.

Since the CMT would be greater than the regular tax, it would prevail. And the firm would continue to pay $750 in tax—even though it makes additional outlays. Thus, the tax saving on the $500 of added IDCs would be zero cents per dollar, not 46 cents; and the after-tax cost would be 100 cents per dollar spent, not 54 cents. That sort of tax treatment could only discourage drilling—in an era when more investment is a critical national need.

Even if the extra $500 were not a "preference" item—say, an increase in wages attributable to hiring more workers—the tax payable would be reduced by only 15 cents on the dollar, not 46 cents. The regular tax would be $520, as above. The CMT would be $675: $1,130 plus $370 plus $3,000 equals $4,500; or $4,500 times 15 percent equals $675.

The new tax payable would be $75 less than before: $750 minus $675 equals $75.

A tax saving of $75 with an added outlay of $500 would be 15 cents on the dollar: $75 divided by $500 equals $0.15

Looked at the other way, the after-tax cost of the wage increase would be 85 cents on the dollar, not 54 cents: $1.00 minus $0.15 equals $0.85

Thus, the CMT would also discourage hiring new workers—in an era of high unemployment.

IV. Conclusion

The CMT would immediately discourage investment and increased employment. The long-term effect would be to impair the nation's energy capacity and reduce the level of economic growth. Accordingly, the proposal must be rejected.

EXHIBIT B

I. THE ADMINISTRATION'S PROPOSED CORPORATE MINIMUM TAX IS A TAX ON COST RECOVERY

The Corporate Minimum Tax (CMT) fails to allow for full cost recovery of preference items, thereby effectively taxing capital. The CMT may place the taxpayer in a worse position than if no preference had ever existed and discourages investment spending. The treatment of intangible drilling and development cost (IDCs) under the proposed CMT demonstrates how the CMT is not a tax on income but, in fact, can be a tax on investment.

Assume a corporation has taxable income of $1,130 computed under the existing rules. Under present law, its regular federal income tax (FIT) liability is $520: $1,130 times 46 percent equal $520.

Under the Administration's proposal, the CMT would be calculated by adding tax "preference'" items to taxable income as determined under existing law to derive a new base, against which a 15 percent rate is applied. Assuming that the taxpayer deducted $3,870 of IDCs (perference under the CMT proposal) in drilling a well, which produced no income until the following year, it would calculate its CMT liability by adding the $3,870 of IDC to the $1,130 taxable income: $1,130 plus $3,870 equals $5,000 CMT base; and $5,000 times 15 percent equals $750 CMT.

Because the CMT of $750 is greater than the FIT of $250, the taxpayer pays the CMT, a tax increase of 44 percent.

A major defect in the proposed CMT is its failure to allow the corporation in a minimum tax position a deduction to recover any significant part of the IDCs in calculating the tax. If full deduction is not allowed for costs incurred in earning

income, the amount of the "income" and the tax thereon is artificially inflated. That is precisely what the CMT does.

If the corporation had never been granted the so-called "preference" but had been required to deduct the IDCs over any reasonable period such as under the new 5-year Accelerated Cost Recovery System (ACRS), and had expended $3,870 in each of the preceding four years, the ACRS deduction in the current year would be $3,870:

Attributable to 4th preceding year (21 percent)	$813
Attributable to 3rd preceding year (21 percent)	813
Attributable to 2nd preceding year (21 percent)	813
Attributable to 1st preceding year (22 percent)	851
Attributable to current year (15 percent)	580
Total current year ACRS deduction	3,870

Since the taxpayer's income before cost recovery of $5,000 would be reduced by the $3,870 ACRS deduction, the CMT base would be only $1,130, the same as regular taxable income, and no CMT would be due. By ignoring cost recovery, a CMT of $230 would be imposed on capital. $750 minus $520 equals $230 tax on capital.

Conclusion

The proposed CMT taxes capital by failing to allow full cost recovery. Such a result cannot be justified if the CMT is to represent a tax on economic income.

II. THE ADMINISTRATION'S PROPOSED CORPORATE MINIMUM TAX WILL REDUCE DRILLING ACTIVITIES AND WELL COMPLETIONS

Virtually all explorers and producers of petroleum, whether independent companies or the larger integrated firms are cash constrained. They budget their activities based on the amount and sources of funds available, i.e., equity capital, cash flow from operations, and borrowings. Typically, tax costs are considered when activities are budgeted. For example, referring to Part I above, the corporation may be assumed to have available to spend, within its budget, $4,390 for IDC and normal tax: $38,700 plus $520 equals $4,390.

But with the CMT, it must drop its expenditures by $230, from $3,870 to $3,640. Although the normal tax increases to $626, the CMT would still be $750: Normal tax—$1,130 plus $230 equals $1,360, or $1,360 times .46 equals $626; CMT—$1,360 plus $3,640 equals $5,000, or $5,000 times .15 equals $750.

Since total expenditures remain the same, the net result is a reduction in drilling activities by $230 or 6 percent.

Another result of the CMT would be to place in jeopardy well completions on marginal projects by increasing completion costs by the amount of the tax. For example, if $1,533 of the $3,870 relates to a marginal well, the anticipated present value of future net income from the well must exceed completion costs by at least the $230 CMT or the well will be plugged as an unprofitable dry hole, thereby reducing the CMT to $520 and saving the $230 CMT. $1,130 plus $3,870 minus $1,533 equals $3,467; $3,467 times .15 equals $520; or $750 minus $520 equals $230.

Conclusion

The CMT will reduce drilling activities and encourage producers not to complete marginal wells.

ACCELERATION OF U.S. TAX ON FOREIGN OPERATIONS

Assumptions.—Taxpayer has oil and gas production operations in the United States and Foreign Country X. Both the U.S. and foreign operations have been profitable. Taxpayer has been electing the foreign tax credit in computing U.S. income tax.

Year 1.—In the year CMT becomes effective, taxpayer launched a large drilling program (committed to before enactment of the CMT) in Country X, thereby throwing his foreign operation into a loss for the year.

Year 2.—Taxpayer's operations in Country X again return a profit and taxpayer pays $200 in foreign income tax. He also elects the foreign tax credit and recaptures all of his Year 1 foreign loss in computing U.S. income tax and CMT.

Year 3.—Taxpayer's U.S. and Country X income preferences remain at Year 2 levels.

Year 4.—Taxpayer reduces his tax preferences, thereby increasing his income subject to U.S. income tax. Taxpayer pays $250 of foreign income tax.

SUMMARY OF CMT EFFECT ON CASH FLOW

Year	Tax paid W/O CMT	Tax paid with CMT	Cash flow difference	Accumulated cash flow
1	92	300	(208)	(208)
2	276	210	(66)	(142)
3	184	180	(4)	(238)
4	322	184	138	0
Total	874	874	0	

Note.—At the end of year 3, taxpayer would have paid a total of $552 if no CMT existed. With CMT, taxpayer has paid a total of $690 over the first three years for a cash flow deficit of $138. If taxpayer's income and preferences remained constant at year 3 levels, it would take taxpayer 35 years to break even on cash flow (before discounting). However, if the CMT carryover was applied to the regular income tax only to the extent needed to reduce the income tax to the CMT level, the 15 year carryover would expire with the taxpayer picking up only $52 of the $138 cash flow deficit at end of the period. For this reason, it is very important to assure that the CMT carryover is applied in full in reducing regular income tax liability as shown in the following examples.

Year and source	Percent	Income base	Preference	Percent	CMT base
Year 1:					
United States		400	800		1,200
Foreign		(200)	1,000		800
Worldwide		200	1,800		2,000
Tax	46	92		15	[1] 300
Year 2:					
United States		400	800		1,200
Foreign		400	600		1,000
Worldwide		800	1,400		2,200
Tax before FTC	46	368		15	330
FTC		[2] (92)			[3] (120)
Total		276			210
CMT carryover		(208)			NA
Tax		68			[4] 210
Year 3:					
Same income and preference as year 2—worldwide		800	1,400		2,200
Tax before FTC	46	368		15	330
FTC		[5] (184)			[6] (150)
Total		184			180
CMT carryover		(142)			NA
Tax		42			[7] 180
Year 4:					
United States		700	400		1,100
Foreign		500	500		1,000
Worldwide		1,200	900		2,100
Tax before FTC	46	552		15	315
FTC		[8] (230)			[6] (150)
Total		322			165
CMT carryover		(138)			NA

Year and source	Percent	Income base	Preference	Percent	CMT base
Tax		184			[9] 165

[1] Carryover 208 (300 – 92).
[2] 46 percent of 200 (400 – 200).
[3] 15 percent of 800 (1,000 – 200).
[4] Carryover 142 (210 – 68).
[5] 46 percent of 400.
[6] 15 percent of 1,000.
[7] Carryover 138 (180 – 42).
[8] 46 percent of 500.
[9] Carryover 0.

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(2) *Chart II.* American Petroleum Institute, "Key Financial Data of Leading U.S. Oil Companies, 1968–80," Discussion Paper #017R, October 28, 1981, Table III, p. 29 (1968–80 data); American Petroleum Institute, "Petroleum Industry Profits: 1981 Fourth Quarter and Year," March 31, 1982, Table I (1981 data).

(3) *Chart IV.* Citibank, Monthly Economic Letter (April issues). 1981 data are preliminary.

(4) *Chart V.* American Petroleum Institute, "Key Financial Data of Leading U.S. Oil Companies, 1968–80," Discussion Paper #017R, October 28, 1981, Table III, p. 29. 1981 data are preliminary API estimates.

STATEMENT OF THE AMERICAN PROTESTANT HOSPITAL ASSOCIATION

Mr. Chairman, The American Protestant Hospital Association's membership is made up of approximately 300 non-profit, religious affiliated hospitals, homes for the aging, health care agencies, and 1600 chaplains and personal members.

It is our understanding that one purpose of the Administration's effort to amend the tax law is to insure that tax-exempt bonds are used for public, rather than private purposes. To suggest that religious, non-profit hospitals operate for other than public purposes betrays a lack of understanding of the role the non-profit hospitals play in the nation's overall health delivery system. The history of religious hospitals in the United States predates the establishment of this nation and this honorable Congress. We do not feel that it is necessary to establish before this Committee that the religious hospitals of this nation, whether they be Protestant, Catholic or Jewish, operate for public purposes. Our purpose in being is to serve the public as part of our religious beliefs.

The American Protestant Hospital Association strongly opposes any attempt to deny access to our member hospitals to the tax-exempt bond market because of the devastating effect it would have on our hospitals' ability to continue to provide modern health care to our patients and communities at a reasonable cost.

President Reagan has made a major effort to encourage volunteerism and private philantrophy to provide community services vital to our nation. The religious hospitals of this nation have been at this task for more than 300 years. The American Protestant Hospital Association supports the philosophy that Americans should do more to support their community and be less dependent on political bodies, whether they be city, state or federal. Because of this philosophy, we do not believe that the Treasury Department's efforts to block non-profit hospitals' access to tax-exempt bonds has the support of the American people, this Congress or President Reagan.

The American Protestant Hospital Association rejects the Treasury Department's argument that the present system results in revenue losses to the Federal treasury. Rather than revenue losses, the non-profit hospitals generate millions of dollars annually in contributions and volunteer services that would otherwise result in a greatly increased cost of hospitalization. These costs would be borne by industry, government and society as a whole. Without the uncounted voluntary contributions of the non-profit hospitals, the costs of health care to Federal, State and local gov-

ernments would be much higher. The Treasury Department's proposal would, if adopted by this Congress, result in substantially higher hospital costs in the future.

Tax-exempt funding for non-profit hospitals began in 1966, and there has developed a substantial market for these bonds since that time. By 1976, according to earlier testimony, about 67.9 percent of the capital requirements were met by debt financing, and about 50 percent of this was satisfied by tax-exempt borrowings. The proportion of new hospital capital derived from debt financing has remained nearly constant in the 70 percent range. The Council of State Hospital Finance Authorities predicts that the sources of capital for the nation's 501(c)(3) religious and non-profit hospitals will continue at about this level through the 1980's.

Most of this hospital construction financing is for modernization and renovation of existing facilities (72 percent), not construction of new, unneeded facilities as the Administration testimony suggests. Furthermore, approximately 30 percent of all tax-exempt hospital bonds are issued for refinancing of existing debt, not construction. Fully 70 percent of the construction, according to state government health authorities, has no effect on bed capacity.

If the Reagan Administration's proposal to end tax-exempt financing is approved by this Committee, it will greatly hamper the non-profit sector's ability to continue delivering adequate, low-cost health care. Currently, many tax-exempt, religious and community hospitals are being forced to compete for patients, doctors, nurses and medical technicians against the investor-owned hospitals who are being reimbursed for an 18 percent return on equity over and above those costs paid to non-profit hospitals. Under these conditions, it is not surprising that tax-exempt hospitals, who are paid at a lower rate, find it more and more difficult to hold down costs.

The tax-exempt status now enjoyed by non-profit hospitals does not afford the advantages the Treasury Department suggests. In fact, charitable, non-profit hospitals are on a rough after-tax parity with investor-owned hospitals who benefit from a series of investment tax credits and accelerated cost recovery system enacted under the 1981 tax law. These and other benefits enacted last year do not apply to tax-exempt hospitals, since they pay no tax. But these benefits enable a borrower, i.e., an investor-owned hospital, with whom tax-exempt religious hospitals must compete for available capital, to pay a higher rate of interest on all borrowing it undertakes. As George Phillips, Jr. testified earlier, "In an environment where capital financing by taxable borrowers is stimulated by investment tax credits and accelerated cost recovery allowances, restricting the tax exemption on the interest on borrowings by section 501(c)(3) organizations is discriminatory against such organizations . . . Tax-exempt hospitals do not benefit from the capital incentives enjoyed by taxable borrowers. Therefore, tax exemption on borrowings by such hospitals is necessary to place them in a competitive position with that of the private borrowers."

Without the tax-exempt bond market to turn to, the non-profit hospitals will be forced into the open market for capital funds. A superficial look at the patient mix of non-profit hospitals should sound an alarm in the Treasury Department because of the large portion of Medicaid and Medicare patients who now receive subsidized health care from the non-profit sector. If these hospitals fail to maintain accreditation, fail to modernize, and cannot remain fiscally viable, the future cost to the Treasury Department will be staggering.

Another section of the Administration's proposal also gives evidence that the Treasury Department is unfamiliar with the process by which hospitals are permitted to remodel, expand or add new services. This unusual section suggests that each bond sale must have the approval of the Governor or the Legislature after a public hearing or voter's referendum. Apparently the drafters of this paragraph were totally ignorant of the Certificate of Need process. Before a hospital may commit funds, it must undergo a lengthy, expensive CON process, which includes public hearings in which every segment of the community, both public and private, provider and consumer, is encouraged to participate. This proposal would increase the time necessary to obtain all the approvals required to issue the bonds and would result in additional legal and construction delay costs . . . costs that eventually must be paid by someone.

The Reagan Administration/Treasury Department raid against the non-profit hospitals is an ill-conceived line of attack that will weaken the front line troops who are fighting to contain rising hospital costs through contributions, volunteerism, and community support. We respectfully urge this Committee to blunt this attack before it unwittingly destroys the religious, non-profit, community hospital sector of the health care delivery system.

AMERICAN RETAIL FEDERATION,
Washington, D.C., April 23, 1982.

Hon. DAN ROSTENKOWSKI,
House of Representatives,
Washington, D.C.

DEAR CONGRESSMAN ROSTENKOWSKI: The American Retail Federation (ARF) strongly opposes any proposal to eliminate the income tax deduction for certain consumer credit interest payments.

Membership in ARF consists of 33 national retail trade associations, 50 state retail associations, the greater Washington Board of Trade, as well as corporate members. Through its members, ARF represents more than one million retail establishments.

Most retailers represented through ARF offer or extend consumer credit in some form, and the vast majority of this credit is made available under revolving or installment plans that provide for the payment of finance charges on outstanding unpaid balances. Retailing, and through retailing, the entire economy would be hurt by S. 2214. Retail credit is extended to consumers to finance general merchandise purchases—not the acquisition of dwelling units, or the acquisition of passenger automobiles, or any of the other types of indebtedness upon which "qualified interest" would be paid under the amended provisions of § 163(b)(1) of the Internal Revenue Code as it is proposed in section 2 of S. 2214. Thus, retailers are justifiably concerned over the discriminatory treatment that Section 2 of S. 2214 would afford to credit extended by members of the retail industry.

ARF believes that S. 2214 would cause a severe misallocation of credit resources by discouraging the use of certain types of consumer credit. This misallocation of resources would place retailers at a severe competitive disadvantage in making goods and services available to consumers. The retail industry suffered through the fiasco of the credit restraint program initiated in March 1980 that produced severe marketplace dislocations far beyond simply affecting the amount of credit extended. That program had a severe, adverse impact on total sales and, thus, bottom line profits.

Current economic conditions are already being felt in retail operations. The opening of new stores is being postponed or canceled completely; older, less efficient stores are being closed; and some retailers are simply closing their doors forever. The discriminatory impact that Section 2 of S. 2214 would have on the retail industry will serve only to exacerbate this decline.

The retail industry is a major employer, with 14 million persons on its payroll. Every dollar invested in the retail industry supports three times the number of permanent jobs that a dollar invested in manufacturing supports. Moreover, the retail industry stimulates employment in the inner city (and elsewhere) of many persons who otherwise would be unemployed, such as semi-skilled workers, senior citizens, and part-time employees.

The retail industry firmly believes that the compelling consideration in formulating the tax structure of this Nation should be equity for all segments of business; to the extent that inequities exist, they should be eliminated. Section 2 of S. 2214 would produce the opposite result: it would have a severely discriminatory impact on the retail industry by placing credit extended by general market retailers at a competitive disadvantage with credit extended by many other types of creditors.

Although general market retailers do, from time to time, extend credit in connection with the rehabilitation of a dwelling unit, there is generally no practicable way to identify the finance charges (i.e., interest) for those credit extensions if the consumer uses the retail credit account for other purchases. In such cases, all purchases are charged to the same account, and finance charges are computed montly on an outstanding balance. Payments on the account are not applied to specific purchases, but to the reduction of the entire account balance. It is very costly and extremely difficult to determine just how much of the total finance charge is for the dwelling unit rehabilitation credit (and is thus "qualified interest") and how much is for other credit purchases.

Retailing is a vital part of the country's economy and a key to a recovery process. Taxes are paid at both the state and local level, services are purchased from the local economy and retailers are major employers. All of which make the health of the nation intertwined with the health of the retailing industry. Manufacturing can only be full capacity when retail stores are selling at full capacity. Retailing's general mechandise price index has consistently been lower than the CPI and many economists believe that consumers will lead the country to recovery.

Yet consumer spending would be retarded by any proposal to limit consumer credit deductions. Credit controls of any sort are a sales disincentive and this cer-

tainly is a form of credit control. Retail sales declines 0.5 percent in March with predictions that they will probably remain sluggish. In addition to weak sales, there also is a continuing weakness in consumer credit installment debts since the 1980 recession, according to the Federal Reserve Board.

We urge you not to add another blow to retailing and the economy by excluding consumer credit interest deductions.

Sincerely,

LOYD HACKLER, *President.*

[From the Wall Street Journal, Tuesday, Apr. 20, 1982]

LIKE OL' MAN RIVER, CONSUMER SPENDING KEEPS ROLLING ALONG IN RECESSIONS AS IN RECOVERIES

(By Alfred L. Malabre, Jr.)

Profits sag. Bankruptcies soar. Unemployment edges toward double-digit levels.

When so much business news seems bleak, what keeps general economic activity from dropping even more sharply than it has in recent months?

The answer can be glimpsed in the top section of the adjoining chart. It traces the level of consumer spending through 15 years of recession-interrupted business growth. The numbers, stripped of inflation, are in terms of the dollar's 1972 buying power.

The unmistakable message is that consumer spending, in real terms, has shown a remarkable staying power since the latest recession began last July. (The shaded areas show the recessions of 1969–1970, 1973–1975 and 1980; there isn't any shading for the latest recession because its length remains unknown.)

HARD-TO-SPOT RECESSIONS

All the recessions, in fact, are hard to spot within the long, slow spending rise. Headline-grabbing slumps show up in consumer spending as slight dips, at the worst. (To see the recessions clearly, one must refer to the chart's lower section, which traces the far bumpier performance of spending just for durable goods—a category containing such things as cars and home appliances.)

You can't have a long, severe recession without a long, severe shrinkage in consumer spending," comments Geoffrey H. Moore, director of the Rutgers Center for International Business Cycle Research in Newark, N.J. "Consumer spending is the backbone of the economy and it's a strong backbone."

Consumer spending amounts to about two-thirds of the gross national product, the broadest measure that economists have yet constructed of overall business activity. Services, which constitute about 48 percent of all consumer spending, show a rise throughout the years covered by the chart. Nondurable goods, which account for just over 38 percent of the spending total, show a slight rise in some recessions and a slight dip in others. The volatile durable-goods group accounts for less than 14 percent of consumer outlays, though it surely commands more than 14 percent of recession-news headlines.

Mr. Moore recalls that between 1929 and 1933, when the Great Depression hit bottom, all three spending segments fell sharply, and that total outlays plunged more than 40 percent. In the current recesson, in contrast, consumer spending, adjusted for inflation, has actually climbed slightly; estimates place outlays in the quarter just ended at an annual rate of slightly over $960 billion, up from $957.5 billion in the final 1981 quarter. Spending is 1981 as a whole totaled $958.8 billion.

"Despite the continuation of the recession, real consumption has increased in every month since last November," notes a study by economists at New York's Chemical Bank. Carol Brock Kenney, senior economist at Shearson/American Express Inc. in New York, remarks: "The consumer certainly played an important role in the first quarter of 1982, when the rest of the economy fell at a 15 percent (annual) pace." Other major parts of the economy include business and government expenditures.

Aubrey H. Zaffuto, economist of J. Henry Schroder Bank & Trust in New York, analyzes spending data since the first quarter of 1980, two years spanning the very short and mild 1980 recession as well as the latest slump. In that span, he estimates, real consumer spending has risen 2.5 percent, while real GNP declined 1.7 percent. He adds: "The only items on which consumers significantly reduced real spending in the past two years have been automobiles, off about 15 percent, and gasoline, down a little more than 2 percent.

Looking ahead, most analysts expect that consume outlays will continue to buttress general economic activity. A major consideration is that real after-tax income, which despite the recession rose modestly through 1981, will continue to climb in coming months, very likely at an accelerating rate.

"We estimate that real disposable income could rise at a 2.4 percent annual rate in the second quarter," says Lacy H. Hunt, chief economist of Philadelphia's Fidelity Bank. "With the tax cut taking effect on July 1, real disposable income should rise at an annual rate slightly over 10 percent in the third quarter." The upshot, he reckons, will be a succession of healthy gains in real spending—about 5 percent annually in the third and fourth quarters of this year, 5.7 percent in the first quarter of 1983 and 6.9 percent in the second.

A RESPONSE AT RETAIL

Otto Eckstein, a Harvard economics professor who also heads Data Resources Inc., an economics consultant based in Lexington, Mass., comments: "If the past, as exemplified by the large tax cuts of 1964 and 1975, is any guide, retail sales will show a sizable response to the (scheduled) $33 billion personal tax reduction and the $12 billion increase in Social Security benefits."

The economist cautions, however, that "the typical individual tax reduction isn't large enough to finance the purchase of an automobile, so the initial impact should come in such fields as clothing, shoes and appliances. But as the purchasing power pulses through the economy, the benefits will spread into all categories of consumer spending."

The recent unwinding of last year's price spiral also should serve to bolster income and expenditures, many forecasters maintain. "The 97 million Americans who are employed will enjoy a 'double tax cut' in 1982," says Carol Brock Kenney, explaining that "the $30-to-$40 billion in relative savings from food and energy costs will equal the savings from the July tax cut." Consumer spending, she predicts, will "grow every quarter this year."

Paul Markowski, economist of Sterling, Grace & Co., a New York investment firm, stresses that while "corporate liquidity is in a shambles," consumer liquidity "has continued to improve." And Irwin L. Kellner, economist of Manufacturers Hanover Trust in New York, notes that "the percent of take-home pay required to service installment debt has fallen to one of its lowest levels in about 15 years." Below 15 percent in recent months, the precentage exceeded 18 percent in the late 1970s.

"People are leery of going into debt because of all the discouraging words they read and hear these days," the economist says.

A RECOVERY ABOUT NOW

"It is our belief that the consumer will lead the economy forward" in a recovery starting about now, declares an analysis by Merrill Lynch Economics Inc., a unit of the diversified New York financial concern. The study cites particularly the "positive consequences" likely to flow from the July tax cut and the "salutary effects" of sharply reduced inflation.

While such optimism is clearly the consensus view, several less encouraging factors lend a cautious tone to many forecasts. Surveys find a disturbing decline in consumer confidence. New York's Conference Board, a nonprofit research group, reports that its consumer-confidence index fell last month to a level of 53.3, on a base of 1969–70 as 100. This was five points below in February level and the lowest reading since May 1980, near the nadir of the last recession. Nearly half of the 5,000 households polled called business conditions "bad." Only 31 percent felt that way a year earlier.

Such findings hardly suggest briskly rising consumer demand just down the road. However, some analysts detect a silver lining. "It's notable that in each of the prior three recessions, the biggest decline in confidence came at the close of the recession," observes Morris Cohen, who manages a consulting firm in Hackensack, N.J., that bears his name.

Many analysts also worry that the rate of income being saved remains exceptionally low. At roughly 5 percent of after-tax income in recent months, the saving rate has been appreciably below levels usually prevailing in the latter stages of recessions. The saving rate climbed above 8 percent, for example, in both the 1969–70 and 1973–75 slumps.

Mr. Zaffuto of Schroder Bank & Trust attributes the low saving level partly to a lingering "inflation psychology" in which it seems best to "buy now to avoid the price rise," as well as to a home-price spiral that has prompted many homeowners

to "think of their home as a savings account which appreciates every year, a handy and painless form of saving."

Now, of course, the situation has changed. Not only has inflation abated sharply but home values in many areas are actually on the decline. "For some consumers, the new reality should have already sunk in," Mr. Zaffuto remarks, adding that "the decision to save will be further bolstered by the fact that money market funds are paying around 13.5 percent," far above the inflation rate. A turn toward frugality, he notes would obviously act to limit any pickup in spending.

Relatively high interest rates are only one reason that many "consumers are in no mood to lead a recovery," cautions Edward Yardeni, economist of E. F. Hutton & Co., a New York securities firm. "The key to consumer spending is jobs; as long as employment is falling, a rebound in spending is impossible."

Shearson's Miss Kenney suggests that uncertainty in Washington over the ultimate size and shape of the federal budget and taxes may be causing consumer confidence to "wilt." Lately, concern over the large prospective deficit in the federal budget has brought calls for higher taxes and federal-spending cuts. Both moves, if made, could prompt at least a temporary tightening of purse strings, some analysts say.

Foreign products command far larger shares of such important industries as the auto business nowadays than in earlier decades, some analysts note. This development, they caution, would tend to limit the degree to which a pickup in consumer outlays later this year would stimulate the U.S. economy.

Statement of Gerard Swarthout, Jr., for the American Road & Transportation Builders Association

Mr. Chairman and Members of the Committee, my name is Gerard Swarthout, Jr. I am president of the Contractors Division of the American Road & Transportation Builders Association, and Executive Vice President of the Scott Bridge Co., Inc. of Opelika, Alabama. Today, I am representing the American Road & Transportation Builders Association.

The American Road & Transportation Builders Association is a national transportation organization consisting of over 4,600 firms and members, headquartered in Washington, D.C. Our members are involved in all aspects of the transportation construction industry. The membership includes contactors, public officials at all levels of government, planning and design professionals, manufacturers and distributors of construction equipment, producers and suppliers of materials and services, representatives of the traffic safety industry, and educators in the field of transportation engineering.

Today, I want to discuss the adverse implications on construction-type contracts of the Administration's regulatory proposal to amend current regulations regarding taxation of long-term contracts; and also, the Administration's proposal for legislation that would disallow the use of the completed contract method of tax accounting.

The completed contract method of accounting has been permitted on construction-type contracts since 1918 due to the unique nature and inherent risks encountered in construction-type work. For instance, the construction contractor agrees to firm prices at the time he submits his bid for the work on a competitive basis. The actual profit on the contract is determined a great deal on weather conditions, differing soil conditions, and other factors beyond the control of the contractor.

In addition, nearly all construction contracts contain retention clauses that could actually exceed the profit on a particular project. In many cases, no profit is realized until retainage is paid, following final acceptance of the completed contract.

The contracting industry operates in a very high-risk atmosphere and with a very low profit normally expected.

In view of these factors, it is virtually impossible to realistically estimate the profit on a construction project until the project is completed.

REGULATORY PROPOSAL

The regulatory proposals suggested by the Administration would make it virtually impossible for average contractors to continue to use the completed contract method of accounting. Since our industry is composed of small contractors, the restrictions and requirements altered in their proposal are so detrimental that many of these smaller contractors simply would not survive.

For many small contractors working in the field of highway construction, it is accepted practice for a large part of the firm's working funds to be derived from

monthly progress payments. In line with this practice, many state and local highway agencies provide for a lump-sum payment for mobilization, to help the contractor meet the early costs of moving equipment to the job site and beginning operations. Without substantial progress payments early in the course of the contract, many small contractors would find it extremely difficult to maintain adequate cash flow. However, these early payments are in no way related to the expectation of eventual profits.

Historically, the small contractor has contributed greatly to the success of the highway construction program. His willingness to accept risks and his ability to perform work with minimum overhead has made the highway industry an important avenue of opportunity for the small businessman. It would be a tragedy if small contractors are forced out of the field by ill-considered Federal regulations which are intended to increase the tax revenues derived from large businesses.

Further, these regulations were thoroughly reviewed and revised in 1976; and we see no further need to change these regulations at this time regarding construction contracts.

LEGISLATIVE PROPOSAL

The Treasury Department's legislative proposal would completely eliminate the completed contract method of tax accounting. The proposal would include a new method of accounting called the progress payment method. For many reasons, progress payments do not directly relate to the cost of performing the work or profit because of cash flow management practices used in the construction industry. It also ignores the risk factors that will vary from year-to-year of the contract.

Neither the proposed regulatory or legislative changes in the handling of long-term construction contracts accounting methods are considered fair or practical for construction-type projects. If either change is implemented, our construction industry, which is already suffering badly, would be dealt such a severe blow that many of our contractors would not survive.

STATEMENT OF AMERICAN TRUCKING ASSOCIATIONS, INC.

The American Trucking Assoications, Inc. (ATA), appreciates this opportunity to present the trucking industry's views on the Administration's proposal to revise and expand the corporate minimum tax.

ATA is the national association of the trucking industry. It has affiliated associations in each state and thirteen national conferences. ATA represents every type and geographical scope of trucking operation in the United States. The great majority of these carriers would be impacted by these proposed changes.

Less than a year ago, we testified before this Committee and asked that you give consideration to a legislative proposal allowing motor carriers to write off as an ordinary deduction their loss in investment of an asset unique to the motor carrier industry. Many carriers had expended substantial sums in the past to purchase operating rights for use in their business, and these rights had been rendered worthless by the Motor Carrier Act of 1980. The economic loss that resulted seriously threatened the financial stability of the industry. As Congress suggested in the report accompanying the Motor Carrier Act, equity demanded legislative action.

In accordance with that suggestion, this Committee voted to approve legislative language to clarify the Internal Revenue Code so as to expressly allow an ordinary deduction for operating rights over a 60-month period. The full House of Representatives approved this measure, which became Section 266 of the Economic Recovery Tax Act of 1981. This legislation became law on August 13 of that year, only 7 months ago.

The deduction for operating rights in Section 266 allows the motor carrier nothing more than the loss which was sustained in 1980 when the adoption of the Motor Carrier Act stripped them of their value. Therefore, because of the non-recurring nature of this write-off, it is unique among the proposed tax preferences, in that it will not result in future action or investment by the taxpayer that might eliminate his tax liability completely unless limits are placed on its use. The events giving rise to the deduction under Section 266 are in the past. The provision allows a deduction for the future only because Congress chose to spread this loss over 60 months.

It must be emphasized that Congress already has acted to reduce the tax deduction realized by the carriers from this write-off. Instead of allowing the carriers to deduct their loss in the year the operating rights became worthless, when worthless assets ordinarily are written off, Section 266 requires that this loss be taken over a

five-year period. Treating the deduction as a preference item would amount to a retroactive amendment of this provision to stretch out its benefits even further.

Such a result would come as a severe blow to the trucking industry in view of its already weakened economic condition. The changes brought about because of the passage of the Motor Carrier Act, coupled with the poor state of the economy, has had a serious adverse financial impact on the motor carriers and their employees.

Preliminary results for the third quarter of 1981 indicate that profit levels declined 12 percent from the already depressed third quarter earnings of 1980. In addition, it is estimated that 100,000 of the 400,000 Teamsters nationwide currently are on lay-off status and more than 50 carriers, many of substantial size, have closed their doors causing more than 17,000 employees to lose their jobs since the Motor Carrier Act was passed. Because of its depressed financial condition, the industry's taxable income is down substantially. Yet, the lower a carrier's earnings, the more likely it will be subject to minimum tax, if the Section 266 deduction is treated as a preference item.

As ATA has indicated, the deduction of operating rights allowed by this provision is not a tax incentive for future investment like the other items listed as tax preferences, but a recognition for tax purposes that a loss was sustained in the past. Including this deduction as a tax preference would amount to a retroactive amendment of Section 266b which, in many instances, would spread the loss sustained by the carriers in 1980 over an even longer period than 60 months. Such treatment could further penalize motor carriers by imposing a burdensome minimum tax solely because profit levels have been severely reduced since the passage of the Motor Carrier Act. We urge the Committee not to curtail the provisions of the recently passed Section 266, but instead to eliminate the deduction for operating rights from the tax preference list.

STATEMENT OF ROBERT G. TAYLOR, PRESIDENT, ASSOCIATED ACCOUNTING FIRMS INTERNATIONAL

Associated Accounting Firms International supports the statement of the American Institute of Certified Public Accountants which opposes the proposal of the Department of the Treasury to eliminate or restrict the use of the completed contract method of accounting.

The members of Associated Accounting Firms International are thirty-two local and regional accounting firms with nearly two hundred offices in thirty-seven states, Canada and Britain. These firms have many contractor clients in a variety of industries who use the completed contract method of accounting and who would be severely and adversely affected by elimination of this method. The completed contract method has been widely accepted and relied upon by contractors for over sixty years. The American Institute of Certified Public Accountants recognizes the completed contract method as acceptable under generally accepted accounting principles (GAAP).

The statement of the American Institute opposes the legislative proposal for the elimination of the completed contract method for several reasons:

(1) the improper analysis of the completed contract method under GAAP by the Treasury Department, (2) the imposition of requirements resulting in "extensive and onerous record keeping", and (3) the detrimental effect on a very competitive industry for the sole purpose of revenue enhancement.

The statement repudiates the explanation of the Treasury Department's proposal in several aspects, including comparison of the accrual method and application of the "all events test".

The member firms of Associated Accounting Firms International believe that elimination of the completed contract method would be a particularly onerous burden to small and medium sized contractors at a time when the economy has placed great strains on their very existence. Furthermore, the proposal, if accepted, would mean that construction contractors would be forced to accelerate the payment of taxes on profits they often times would not yet have determined or received for construction projects in process. This could result in a weakening of their capacity to financially support new projects, thus fueling the fires of unemployment.

The typical contractor client of the member firms has used and understood the completed contract method for many years. The method is widely accepted in contracting industries of many types, including construction, installation and manufacturing. The completed contract method provides one fixed time for gain or loss recognition, the completion of the contract, and the contractor can report such with certainty. The particular economics and cash flow needs of contracting industries

necessitate the type of reporting required by the completed contract method. The elimination of the method could easily result in negative cash flow and be particularly harmful for short term contracts performed by small contractors.

Associated Accounting Firms International supports the position of the American Institute of Certified Public Accountants, opposes the elimination of the completed contract method of accounting and is available for further comments or consultation on the matter.

ASSOCIATED HOSPITAL SYSTEMS,
Farmington Hills, Mich., April 1, 1982.

Hon. DANIEL ROSTENKOWSKI,
Chairman, House Ways and Means Committee,
Longworth Building, Washington, D.C.

DEAR MR. CHAIRMAN: Associated Hospital Systems strongly objects to the Administration's proposals to impose restrictions on the tax exemption of bonds for tax exempt organizations, especially non-profit hospitals. It is our hope that you will include this statement in the hearing record for the hearings of the Committee scheduled for April 6. We appreciate the opportunity to submit these comments.

ASSOCIATED HOSPITAL SYSTEMS (AHS)

AHS is comprised of ten systems of hospitals that are exempt from federal taxation under Section 501(c)(3) of the Internal Revenue Code. The systems, as indicated on our stationery, cover a wide geographic region of some 22 states; owned, leased or managed over 150 hospitals with approximately 30,000 acute care beds. Our member systems pride themselves on the public service they provide in their many communities as voluntary, non-profit organizations. To provide this service requires some $2 billion annually to support the related costs.

ADMINISTRATION CONCEPT

It is our understanding that the Administration proposes to impose a variety of new restrictions on use of tax-exempt bonds. Four of these proposed restrictions adversely affect non-profit hospitals.

(1) The highest elected official or legislative body, for example, the Mayor or City Council, of the governmental unit issuing the bonds and in which the facility is located, must approve the bonds after a public hearing. Alternatively, the public approval requirement could be met by a voter referendum on the bonds to be issued for the particular facility.

(2) In the case of bonds issued after December 31, 1985, the governmental unit must make a financial contribution or commitment to the facility financed with tax-exempt bonds. The contribution could take the form of a cash payment, tax credit or abatement provision of additional services, or payment of the bond issuance expenses with a value on the date the bonds are issued equal to 1 percent of the face amount of the bonds. Alternatively, the issuing governmental unit can satisfy the commitment requirement by insuring or guaranteeing the bonds or by designating the bonds as general obligations of the state or local government. As is discussed below, the application of this requirement to non-profit hospitals—which state and local governments already exempt from taxation—is ambiguous in the Treasury Department's description of the Administration's proposal.

(3) Each bond must be registered, not bearer, form.

(4) Restrictions on the investment yield from the use of the proceeds of the obligations are extended to reserve funds and funds held during the temporary construction period. Bond costs may not be taken into account in determining the yield for purposes of the arbitrage limitations.

Other restrictions would be applied to "small issue" industrial revenue bonds issued under Section 103(b)(6) of the Internal Revenue Code. These restrictions would include limiting the availability of IDB's to small businesses and requiring that entities choose between the tax exemption and use of the ACRS provisions of the Economic Recovery Tax Act. These provisions do not apply to bonds issued by tax-exempt organizations.

The proposed restrictions on non-profit hospital bonds appear to be based on several premises:

Bonds issued for non-profit hospitals are utilized for "private" activities.

The Treasury will gain substantial revenue through limiting the current exemption for interest earned on bonds issued for non-profit hospitals.

Implicit in the Treasury's discussion is the further premise that non-profit hospitals have access to other forms of capital to finance their needed renovations and other projects.

We would like to discuss these premises in some detail.

TAX-EXEMPT HOSPITALS SERVE A "PUBLIC" PURPOSE

Insofar as the I.R.S. is concerned, hospitals exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code of 1954, as amended, are clearly serving a "public rather than a private interest." (I.R.S. Reg. 1.501(c)(3)-(1)(d)(ii).) Thus, characterizing hospital bonds as being used for "private" activities is inconsistent with the basis on which the I.R.S. grants tax-exempt status to such hospitals. The exempt purpose of such non-profit hospitals is further exemplified by the provision of free services to many individuals, as was a requirement for many of these hospitals in order to receive grants under the so-called Hill-Burton program.

CLAIMS OF ABUSE ARE UNSUBSTANTIATED AND IGNORE OTHER CHECKS AND BALANCES IN THE SYSTEM

The Treasury Department's February 26, 1982, explanation does not allege that tax-exempt bonds have contributed to construction of unneeded hospitals, but this allegation has been made in the past. This allegation ignores not only the existence of other regulatory checks, but also ignores the workings of the financial marketplace. Hospitals seeking to secure debt through the issuance of tax-exempt bonds must compete on the open market for the investor dollar. The institutional or individual investor must choose between numerous investment options. The fact that many such investors have historically chosen to invest in a hospital bond reflects not only a recognition of the prudence of issuing such debt (in their opinion), but also their willingness to support such public purposes.

Numerous regulatory checks also exist in the system suggesting that, if unneeded hospitals have been financed through tax-exempt bonds, the existence of such an exemption can hardly be held as a casual factor. Zoning laws, state certificate of need and licensure laws, state rate review programs, and other state and local initiatives provide that a myriad of approaches must be obtained prior to ever issuing tax-exempt bonds for the purpose of financing such projects. Further, the current process of issuing such bonds is subject to continuous public scrutiny. We remain unclear that abuses in the issuance of such bonds have occurred.

It is unclear that the growing use of tax-exempt financing by hospitals has contributed to any growth in capital expenditures, let alone construction of unneeded hospitals. In fact, there is no demonstrated relationship. During the period 1973–1979, when the portion of hospital construction financed with tax-exempt bonds rose from 21 percent to 49 percent, private hospital construction spending was relatively stable rising from $3.05 billion in 1973 to $4.3 billion in 1979 (our most recent data). When inflation over the period is considered, the real value of hospital construction actually dropped to $2.6 billion in 1979. Most of this tax-exempt financing is used for renovation, modernization, and replacement of existing facilities and refinancing of existing debt, not construction of new beds.

IMPOSING RESTRICTIONS ON NEW HOSPITAL BONDS WILL NOT SUBSTANTIALLY INCREASE FEDERAL REVENUE

The Treasury Department does not and cannot claim that its proposed restrictions would have much, if any, short term impact in increasing federal revenue and in reducing burgeoning deficits. In fact, for Fiscal Year 1983, the Treasury Department acknowledges that its proposal would result in a net loss in revenue of $200 million. The Administration has released no estimates on the revenue it expects to gain in fiscal 1984 or 1985 from that part of its proposal restricting the tax-exemption for non-profit hospital bonds [1] but the Fiscal 1982 Carter Administration budget estimated that the increased revenue in Fiscal 1981 and 1982 from restricting the ex-

[1] The Administration projects a revenue gain of $300 million in Fiscal 1984 and $1.1 billion in Fiscal 1985, but these figures are for restrictions on all tax-exempt revenue bonds, not just those of non-profit hospitals. Currently, tax-exempt bonds for non-profit hospitals constitute approximately 11 percent of the total volume for tax-exempt revenue bonds, indicating that the Administration expects its proposed restrictions on hospital bonds to increase Federal revenues by only $33 million in Fiscal 1984 and $121 million in Fiscal 1985. These are the same estimates given in President Carter's Fiscal 1982 budget for Fiscal 1981 and 1982.

emption would be only $35 million and $135 million, respectively (fiscal year 1982 Budget Special Analysis G, page 231).

These estimates of revenue gain do not take into account the offsetting increases that would occur in federal outlays under the Medicare and Medicaid programs due to the increased cost of capital that would result from taxable debt. AHS currently has outstanding approximately $900 million in combined long-term tax-exempt debt. With a 33.2 percent rate of Medicare and 7.2 percent rate of Medicaid utilization, this means that for every additional dollar that AHS must pay in interest rates, Federal government outlays for reimbursement to AHS alone will increase by approximately .37 cents. Assuming a 3 percentage point spread between interest rates for tax-exempt and conventional financing, the annual Federal reimbursement to AHS hospitals on existing debt would be approximately $10,000,000 greater. This increased reimbursement to AHS alone would offset more than one-fourth of all the revenue that the Treasury Department apparently projects it would gain in fiscal 1984 by restricting the exemption for all non-profit hospital bonds.

Rather than focus on the limited, or even negative, revenue impact of restricting the exemption for hospital bonds, the Treasury Department and others have emphasized claims that the estimated revenue loss from the tax-exemption for non-profit hospital bonds is $845 million for Fiscal 1983. This claim, however, is misleading and irrelevant as an indication of the revenue that would be gained should the exemption be restricted. The reason for the vast discrepancy between the revenue loss and revenue gain figures is that the Administration proposes only to apply its restrictions to the exemption for new hospital bonds, not retroactively to the exemption granted in the past for all outstanding hospital bonds. To retroactively rescind the exemption for existing bonds would raise serious constitutional questions. This means that far less revenue is gained from the proposed restrictions on new bonds than supposedly is being lost from the exemption on both new and old bonds.

HOSPITALS' RELIANCE ON TAX-EXEMPT DEBT IS SIGNIFICANT

It is particularly discouraging to us that the Administration might consider trying to cut back on federal health expenditures by cutting off the life blood of hospital debt—tax-exempt bonds. As early as 1977, tax-exempt bonds accounted for the majority of the dollars used for all hospital renovation, modernization and construction. Hospitals have turned to tax-exempt bonds to replace other sources of financing which have dried up, such as government programs and philanthropy. For the Congress to restrict the exemption would have a truly devastating impact on non-profit hospitals.

FINANCIAL CONTRIBUTION REQUIREMENT

On its face, the Administration does not propose that the tax-exempt for non-profit hospitals be completely eliminated. Depending on how the proposal is interpreted, however, it could well have this effect. For example, the Administration proposes that tax-exempt bonds be available only where the governmental unit makes a "financial contribution or commitment to the project" in an amount equal to 1 percent of the face amount of the bond. (General and Technical Explanation at page 28.) This contribution must be "specifically earmarked for the facility or project," meaning that "general tax reductions or regular services provided to all facilities are not counted for this purpose." (Id. at 28–29.) Were this requirement applied to nonprofit hospital bonds, such bonds would not be available. The Constitution in most states would prohibit such a contribution, and in other states facing mammoth federal aid cutbacks, no funds would be available to make such a contribution.

The Administration proposal does state that "general tax exemptions provided for exempt organizations under State law could be used to satisfy the contribution requirement with respect to projects for exempt organizations." (Id.) As stated above, the meaning of this qualification is ambiguous. If it means that State and local governments would not be required to make a financial contribution specifically earmarked to a project of a non-profit hospital, it would mitigate the impact of the financial contribution requirement. Adoption of such a qualification is warranted for tax-exempt organizations because State and local governments already make an indirect financial contribution to such organizations by granting them an exemption from State and local taxes. To require that such governmental units make an additional contribution to each specific project is inequitable and unreasonable. Given the tax-exempt status of non-profit hospitals, a State or local government cannot further abate the State or local taxes of the hospital. This means that any additional financial contribution to a specific project would likely have to take the form of a

direct equity contribution to the project, the form of contribution that specifically is prohibited in many State constitutions.

CONCLUDING REMARKS

The key issue facing hospitals in the 1980s is capital formation. Hospitals are consuming their own capital largely due to current federal reimbursement policies that do not cover full cost of operations and ignore the requirement to reimburse non-profit hospitals for a return on equity. The result, over time, is that hospitals increasingly are assuming greater levels of debt to replace existing assets. As this statement demonstrates, restricting the tax exemptions for non-profit hospital bonds would severely exacerbate the financial strain already felt by non-profit hospitals, impair their ability to renovate and modernize existing facilities, and prevent expansion in those areas where patient needs warrant construction of additional facilities.

In the opinion of the Associated Hospital Systems, it is imperative that not-for-profit hospitals continue to have access to tax-exempt bonds. To deny such access may well result in a significant deterioration in health services to this nation's public.

Please do not support the Administration's proposals regarding tax-exempt hospital bonds. We very much appreciate the opportunity to submit this statement.

Respectfully submitted,

EDWARD J. CONNORS, *Chairman, AHS.*

ASSOCIATION OF AMERICAN MEDICAL COLLEGES,
Washington, D.C., March 9, 1982.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, U.S. House of Representatives, Rayburn House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN. According to its Fiscal Year 1983 budget request, the Administration intends to soon put before you a legislative proposal designed to restrict significantly the use of federal tax-exempt revenue bond financing. Some of the provisions under consideration would virtually terminate the availability of such financing to non-federal, not-for-profit hospitals. For these public purpose institutions, tax-exempt financing now is the source of well over half of their construction capital. On behalf of the membership of the Association of American Medical Colleges (AAMC), I wish to express several concerns regarding this Administration proposal and request that pursuit of this course of action be rejected by you and your Congressional committee colleagues.

The Association's constituency includes all of the nation's medical schools, 74 academic societies, and more than 325 non-federal, not-for-profit hospitals. These hospitals participate in the Medicare program; account for sixteen percent of the admissions and twenty percent of the ambulatory services provided by non-federal short-term hospitals; provided a comprehenisve range of patient services, including the most complex and intensive tertiary care services; and are responsible for a majority of the nation's medical education programs. Moreover, these hospitals account for 35.4 percent of the patient bad debt deductions and nearly half of the charity care deductions at all short-term community hospitals in the United States. Thus, a proposal that would limit the federal tax exemption for interest on private, nonprofit hospital bonds is of direct and vital interest to the AAMC, its members, and the communities and publics they serve.

NO EVIDENCE LINKING TAX-EXEMPT FINANCING TO HOSPITAL OVERBEDDING

Previous efforts to restrict the availability of tax-exempt hospital bonds have been based on the assumption that a causal relationship exists between the use of such financing and the construction of unneeded hospital beds. Treasury Secretary Regan's discussion of the misuse of industrial revenue bonds to build "unneeded hospitals and hamburger stands," which appeared in the January 12, 1982 New York Times, leads one to believe that the current Administration believes similarly.

The AAMC contends that there is no evidence which supports this assumption. In fact, according to the Bureau of Census' own figures, annual completed hospital construction dropped 35 percent between 1971 and 1979 when measured in constant (1967) dollars. Inversely, for the same time period, the Congressional Budget Office (CBO) reports that the volume of hospital tax-exempt bonds issued rose 672 percent. Thus, despite the rapid increase in hospital tax-exempt bond use, hospital constuc-

tion in real dollars declined, strongly contradicting the assumption of a positive correlation between the two.

In addition, the vast majority of hospital construction projects are undertaken specifically to replace or renovate antiquated, inefficient and substandard facilities and equipment, or to convert existing facilities in response to evolving medical practice and patient demand patterns (e.g., transforming inpatient facilities into ambulatory care units). These are necessary and legitimate projects which require capital, but add no new beds to the existing health care delivery system. According to the American Hospital Association's Hospital Construction Survey, only 28.4 percent of hospital capital projects undertaken in 1978 were for new construction. Clearly, the premise that tax-exempt hospital financing invariably results in more beds is erroneous.

EFFECTIVE GOVERNMENTAL AND MARKETPLACE MECHANISMS TO MONITOR THE NEED FOR HOSPITAL CAPITAL EXPENDITURES EXIST

As it argued in its comments on a restrictive proposal made by OMB under the previous Administration, the Association believes that any arbitrary legislative plan to limit tax-exempt financing for hospital capital projects would lead to an inappropriate role for the federal government in the capital marketplace. It would also ignore existing federal health planning authority, and many state regulatory agencies, responsible for monitoring need for major capital expenditures by hospitals.

Under the various Certificate Of Need (CON) review provisions of the National Health Planning Act (P.L. 93-641) and its amendments (P.L. 96-79), Health Systems Agencies (HSAs) and State Health Planning and Development Agencies (SHPDAs) are required to certify the need for capital expenditures, major medical equipment acquisitions, and new institutional health services proposed by hospitals. These decisions must be based on such criteria as the appropriateness of the costs and methods of proposed construction, the application of national guidelines which include a standard for overbeddedness, and the impact on patient care costs and charges at the proposing institution and other area facilities.

Tax-exempt bonds are purchased by private investors in competition with other investment opportunities and are therefore subject to the self-regulating investment market. To limit their risk and assess a hospital's debt repayment potential, investors have historically conditioned their purchase of tax-exempt bonds on CON approval of projects. The certificates are viewed as expressions of community need, economic soundness and the will of the people. These principles have also been of primary importance to state bond issuing authorities in their determinations to approve or deny tax-exempt financing for hospital projects.

In the absence of evidence to support the assumption of a linkage between the availability of federal tax-exempt hospital financing and construction of excess hospital beds, the Association recommends that the federal government maintain its current policy on tax-exempt hospital bonds. It must not attempt to displace the combination of local level decision-making and consumer choice with some form of arbitrary federal statutory proscription and new burdensome regulation.

THE TREASURY'S ESTIMATED REVENUE LOSS DUE TO TAX-EXEMPT HOSPITAL BOND ISSUANCES IS OVERSTATED

The Association respects the Administration's efforts to identify new revenue sources to offset the burgeoning federal budget deficit. However, it must take issue with CBO's current projections of $100 million, $200 million, and $300 million in Treasury revenue losses due to new tax-exempt hospital issues for Fiscal Years 1982, 1983 and 1984 respectively. These estimates are believed to be overstated because:

They fail to account for the reduced federal Medicare and Medicaid reimbursement outlays attributable to the lower interest expenses of tax-exempt financed hospitals; they fail to account for increased personal and corporate tax revenues paid by hospital employers and contractors; and tax rate reductions enacted in the Economic Recovery Act of 1981 will reduce the cost of tax exemptions to the government and the loss of Treasury revenue in turn.

Thus, the AAMC strongly opposes the limitation of federal tax-exempt hospital financing as an overestimated response to the dubious premise that such financing contributes significantly to excess hospital bed capacity and federal government expense.

TAX-EXEMPT FINANCING FOR NON-FEDERAL NOT-FOR-PROFIT HOSPITALS IS BOTH APPROPRIATE AND NECESSARY IN THE PUBLIC INTEREST

Non-federal not-for-profit hospitals are an essential component of our nation's health care system, serving an undeniable public purpose. The vast majority of teaching hospitals in the U.S. belong to this hospital group and provide vital and highly complex patient services, often at no charge to the poor and medically indigent. Additionally, these institutions serve society through their education and research missions which advance biomedical science and technology and supply the nation's health manpower. The proper maintenance and continuing viability of these institutions depends upon their success at capital formation.

Eliminating or restricting significantly the tax-exempt status of hospital bonds would prevent financially weaker institutions from undertaking necessary improvements and would raise considerably the cost of borrowing capital to more financially stable hospitals (and thereby also increase the federal and state level reimbursement claims of these institutions). The federal government's reimbursement policies under the Medicare and Medicaid have had a prohibitive effect on not-for-profit hospitals as well. These policies tend to cover less than the full costs of operation for these hospitals and deny them a return on equity accorded proprietary institutions. Moreover, recent legislative amendments have further reduced federal reimbursement. This has taken its toll disproportionately on the revenue of not-for-profit institutions, and teaching hospitals particularly, because they serve proportionately more Medicare and Medicaid patients.

As a result, the not-for-profit hospitals are rapidly consuming all their own available capital raised through earnings accumulation and charitable contributions and are assuming more and more debt to acquire financing. Because they do not pay income tax and receive no benefits from tax incentives (e.g., investment tax credits or deduction of interest expense), not-for-profit institutions view the tax-exempt financing mechanism as a means of making their borrowing costs comparable to those of proprietary hospitals. Should this mechanism be terminated or curtailed seriously, many of the financially weaker, though essential, hospitals would be forced to join the sizable group of urban and rural hospitals that are operating on the fringe of insolvency.

Furthermore, it must be recognized that the nation's health care delivery system is an integrated and interdependent one. Impairing the ability of not-for-profit institutions to adequately meet community needs and maintain public health will adversely affect, and in many instances irreversibly strain, the capabilities of other public and private hospitals in the country that would have to assume greater responsibility as demand for health services is shifted to them. An erosion of the quality of care in the system inevitably would follow.

CONCLUSION

In summary, the AAMC strongly urges the federal government to maintain its present policy regarding hospital use of federal tax-exempt bonds and discontinue activity to adopt a legislative proposal that would limit such bond use. This recommendation is based on the following grounds:

(1) There is no evidence linking tax-exempt financing to hospital overbedding.

(2) Governmental and marketplace controls exist to monitor the need for hospital capital expenditures and need not be displaced or duplicated.

(3) The Treasury's estimated revenue loss due to tax-exempt hospital bond issuances is overstated.

(4) Tax-exempt financing for non-federal, not-for-profit hospitals is both appropriate and necessary in the public interest.

I appreciate this opportunity to express the Association's concerns and suggestions on the issue of federal tax-exempt hospital financing and hope they will be considered seriously in your deliberations in the days ahead. I, and members of the AAMC staff, would be pleased to discuss these matters further with you at any time.

Sincerely,

JOHN A. D. COOPER, M.D.
President.

96-396 O—82——37

STATEMENT OF RUSSELL F. MCKINNON, EXECUTIVE VICE PRESIDENT, AUTOMOTIVE DISMANTLERS AND RECYCLERS ASSOCIATION

Mr. Chairman and members of the Committee, my name is Russell F. McKinnon. I am Executive Vice President of the Automotive Dismantlers and Recyclers Association (ADRA). I would like to thank the Committee for providing the Association with the opportunity to testify regarding the 1978 energy tax credit provisions, and in support of the proposed revision and extension of the investment tax credits for recycling equipment included in Representative Cecil Heftel's (D-HI) bill, H.R. 2640, the Industrial Energy Security Tax Incentives Act of 1981.

ADRA is a trade association representing small businessmen across the nation who specialize in the dismantling and recycling of unserviceable motor vehicles. ADRA has over 5,500 members and the industry as a whole includes over 17,000 business establishments with annual sales of between 6 and 8 billion dollars.

The member companies comprising ADRA provide a vital service to the American consumer and driving public. Each year, our members dismantle 7-8 million inoperable motor vehicles into parts and components which in turn are sold at substantial savings to customers of all kinds: service stations, repair shops, auto parts rebuilders, car dealership, collision shops and retail customers. As a result, the 17,000 establishments in our industry make an important contribution to the economic and environmental well being of the U.S.—not only through saving consumers substantial sums in car repairs and in helping to keep city streets and neighborhoods free of unsightly wrecked vehicles, but also in another important way: by dismantling cars and trucks and recycling their parts, our industry saves the U.S. an estimated 80 million barrels of oil each year that otherwise would be used up in the manufacture of identical new parts.

THE AUTOMOTIVE DISMANTLING INDUSTRY

The automotive dismantling industry is probably the only industry in the world that recycles 100 percent of its raw materials—in this case inoperable cars, trucks and other motor vehicles. Allow me to explain this by briefly outlining the steps involved.

After a wrecked vehicle is purchased by an auto dismantler, the first step is to remove all reusable parts such as the starter, alternator, engine, transmission, tires, wheels, undamaged glass, and various body components including doors, hood, fenders, bumpers and interiors. These parts and components are then cleaned, tested, inventoried, and sold to various customers such as new and used car dealerships, body shops, automotive repair shops and individuals.

Next, mechanical and electrical parts which are not in reusable condition but are rebuildable are sold to rebuilders as "cores." We are the rebuilding industries' major supplier of "core" parts.

Our industry had found that there is a substantial market for the used parts which dismantlers generate through this recycling process. Used parts are reliable and literally road tested. And, in most instances, they cost less than half the price of comparable new parts, benefitting every segment of the population.

Finally, the remaining hulks of the stripped vehicles are flattened for easy shipment to a shredder where they are reduced into raw materials such as iron, steel, aluminum, platinum, lead and zinc. As you can see, this 100 percent recycling.

Substantial amounts of energy are saved through the automotive dismantling and recycling operation. For example, the American Iron and Steel Institute estimates that the recycling of scrap requires only 50 percent of the energy used in the manufacture of iron from virgin ores. And, the Aluminum Association estimates that recycling scrap aluminum saves 95 percent of the energy required to produce aluminum from raw bauxite ore. Furthermore, the EPA estimates that when scrap steel is used in place of virgin iron ore, there is an 86 percent reduction in air pollution, a 76 percent reduction in water pollution, a 97 percent reduction in mining wastes and a 40 percent decrease in fresh water consumption. The automotive dismantling and recycling industry is proud to play a major role in contributing these benefits to the U.S.

THE ENERGY TAX ACT OF 1978

ADRA believes that the energy investment tax credit provision of the Energy Tax Act of 1978 played an important role in the expansion of the industry's recycling capacity and contributed to a meaningful increase in energy conservation.

As you are aware, section 48(1)(6) of the Energy Tax Act authorized a 10 percent Energy Investment Tax Credit for "recycling equipment." As will be discussed more

fully below, "recycling equipment" was defined in a way which limited the special tax credit to equipment which was used to reduce inoperable vehicles to scrap. Nonetheless, the tax credit was an important incentive for investments in expensive energy saving equipment.

For the average dismantler, most of this equipment was quite expensive. For example, an auto body crusher which flattens an auto hulk into a "slab" of manageable size may cost $18,000; a metal baler may cost as much as $85,000. Our members, and automotive dismantlers generally, are primarily small businessmen. Most of our members had annual gross sales of under $1 million last year; and half our members had sales of less than $500,000. For these businessmen, the energy tax credit was a major factor in their decisions during the last year to invest in new equipment to expand their recycling capacity. In fact, in our judgment, many of our members would not have invested in this new equipment had it not been for the additional energy tax credit.

Because our Association is aware of the impact of the tax credit on decisions by automotive dismantlers to purchase recycling equipment and because we see what these decisions have meant in terms of increased capacity to recycle used vehicles into only one of the three products our industry produces, scrap metal, we cannot understand why some officials have termed the credit "ineffective" and why they have called for its repeal. Clearly, it has been highly effective and has stimulated and rejuvenated this industry. Clearly, we cannot be complacement about measures to conserve our scarce energy resources. We should not forget that one of the reasons the so-called "energy crisis" does not seem as critical today as it may have been a few years ago is that energy consumption has been curbed through a heightened public awareness of the importance of conservation measures such as recycling. We are, however, still dependent on foreign oil, a situation that will not change for years. Although there are domestic fuels and alternate sources of energy which may provide the long-term solution, there is still a critical need to reduce our immediate energy requirements through greater conservation and energy efficiency. As I am sure you are all aware, a report released in 1980 by the National Science Foundation stated that the U.S. could achieve the greatest short term reduction in energy use by conservation measures.

ADRA strongly supports, therefore, the section of H.R. 2640 which extends the energy tax credit provision for recycling equipment. This provision is important because one of the major impediments to investments in auto recycling equipment is a lack of available capital. The automotive dismantling industry traditionally has consisted of small, labor intensive, family-run operations. Recycling equipment costs represent a high proportion of gross income. Tax credits may mean the difference between buying and not buying. And, of course, each purchase represents an increase in the nation's total recycling capacity.

We appreciate Congress' concern regarding the budget impact of H.R. 2640. However, we understand that the cost of the credit for recycling equipment is modest, particularly when compared to other provisions in the bill. Under the circumstances, we believe that the benefits to be derived from the energy conservation which will be achieved by extending the credit for recycling equipment more than outweigh the modest cost.

INVESTMENTS FOR EQUIPMENT TO RECYCLE "RE-USABLE" PARTS

ADRA believes that one of the shortcomings of the 1978 Act is that it limited the credits to equipment used to recover "raw materials," S. Rep. No. 529, 95th Cong., 1st Sess. (1977). This meant that equipment used in the recycling of "re-usable" items was not eligible for the credit. ADRA believes this was a critical oversight because even more energy is conserved through the recycling of re-usable parts than by recycling scrap metal.

For example, very little energy is required to strip parts from a wrecked or inoperable vehicle—most of the energy is in the form of labor. These parts require no significant machinery or manufacturing. Generally, energy is consumed only to separate the re-usable part from the inoperable vehicle, clean it, test it, and in some instances, rebuild it.

However, if a wrecked vehicle is not dismantled into parts, but instead is scrapped, substantial sums of energy are still required in smelting, milling, shipping, manufacturing and parts assembly to make the same parts that were scrapped. This doesn't make much sense.

ADRA believes that this source of energy conservation should be encouraged and that the definition of "recycling equipment" should be broadened to encompass equipment used to recycle used parts. Congressman Heftel's bill appears to correct

this oversight; however, we would like this made even more explicit by a specific reference to the recovery of reusable automotive parts. We believe that the budget impact of such an approach would be de minimus.

Working with the National Tire Dealers & Retreaders Association, Inc. and other associations in the automotive service industry, we have drafted language which we believe will make clear that equipment utilized to recyle usable parts would be eligible for the tax credits:

(A) In general—Subparagraph (D) of section 48(1)(6) (relating to inclusion of certain equipment is amended to read as follows:

"(D) Certain Equipment Included—The term 'recycling equipment' includes any new of replacement property which is used in the conversion or processing of solid waste into a fuel or into useful energy such as steam, electricity, or hot water and any property which is used in the processing of solid waste to recover and store other reusable resources and materials, including, but not limited to paper, ferrous metals, non-ferrous metals, and glass, *and reusable parts and components and retreaded tires.* (New language underscored.)

We appreciate the opportunity to express our views on the energy investment tax rate credits for recylcing equipment. We hope that the Committee will continue the Congressional initiative of 1978 to encourage energy efficiency. We believe that these incentives should be applied equally to the diverse methods of recycling motor vehicles so that the purpose of the Act can be served more completely.

BANCOHIO NATIONAL BANK,
Columbus, Ohio, March 18, 1982.

Hon. DAN ROSTENKOWSKI,
House of Representatives, Rayburn House Office Building, Washington, D.C.

DEAR MR. ROSTENKOWSKI: BancOhio National Bank is pleased to respond to the invitation for comments relevant to the Reagan Administration's recent tax proposals.

The banking industry has been cited as a sector of the economy that pays very little federal income tax because it makes extensive use of provisions in the law viewed as "tax preferences." Therefore, a portion of the Administration's proposals are aimed at increasing the relative tax burden of the banking industry. Before discussing specific proposals of the Administration, we would like to comment on, what we consider, a public misconception about federal income liabilities of commercial banks.

FEDERAL INCOME TAXES—COMMERCIAL BANKS

Many commercial banks have low federal tax liabilities and report effective federal tax rates well below the 46 percent statutory ceiling. These low tax rates are more attributable to the role that commercial banks play as financial intermediaries in the economy rather than a desire to avoid paying federal income tax.

Statistics which purport to show low effective tax rates for banks can be misleading if not viewed from the proper perspective. Because of the method by which bank tax rates are computed, there are misconceptions as to the tax-exempt feature of municipal securities. It is generally recognized that the tax-exempt feature for state and local government securities results in a large inter-governmental subsidy. When the tax burden for a commercial bank is computed, what is highlighted is that the investor-bank pays no tax on interest income from municipal securities. What the statistics fail to reflect is that the commercial bank has accepted a yield on the municipal securities which is lower than the yield on comparable taxable securities in exchange for the tax-exempt feature. By investing in municipal securities with lower yields, the bank has reduced the borrowing costs of state and local governments.

The yield differential, i.e., "yield discount" is, in substance, a subsidy to the issuing state or local government equal to the federal tax that would be payable on an equivalent investment in taxable securities. When the federal income tax liability of a commercial bank is analyzed, the "imputed" tax paid to the issuing government, as part of the intergovernmental subsidy, is not reflected. If this "yield discount" was added to both income before tax and the bank's federal tax liability, the effective tax rate for a commercial bank would increase. The increase would be significant if the bank carried a sizeable municipal portfolio. More importantly, the recomputed federal tax rate would better reflect economic reality—that the commercial bank has "paid" more tax than perceived. Because this subsidy is not reflected in

bank tax statistics, the federal tax burden of commercial banks is usually understated and the economic advantage of the tax-exempt feature to banks is exaggerated.

PREFERENCE FOR MUNICIPAL BOND CARRYING COST/ALTERNATIVE MINIMUM TAX

Based on the foregoing and the comments below, we are of the opinion that the cost of carrying securities that are exempt from federal income tax should not be construed as a "tax preference." By classifying tax-exempt interest as a tax preference, directly or indirectly, the borrowing costs to state and local governments would increase. In addition, commercial banks whose earnings have declined due to economic conditions, and who now have little incentive to invest in obligations of state and local governments, would be unfairly penalized for municipal obligations that they now carry. Commercial banks with net operating loss carryovers would not be allowed to offset the alternative minimum tax with such losses. The alternative minimum tax would adversely affect the earnings of these institutions whose interest spreads have already declined, partially due to lower yielding state and local government issues which must be funded at higher interest costs.

The tax preference for municipal bond carrying costs would be computed by allocating the bank's total interest deductions pro rata across its total investment portfolio to determine the amount of the interest deductions to be added to the minimum tax base. The term "investment portfolio" has not been defined; even so, it would be inappropriate to allocate a bank's cost of funds solely to its investment portfolio. Due to the fundibility of bank assets and liabilities, interest deductions for commercial bank must fund fixed assets, loans, and assets other than municipal obligations. Conceptually, the Administration's proposal can be understood; however, the practical application of the concept would, at best, produce disparate and inequitable results.

TAX WITHOLDING ON INTEREST AND DIVIDENDS

Apparently, a withholding tax has been proposed because the Treasury is unable to track down taxpayers who fail to report interest and dividend income that has been reported to the Internal Revenue Service by third parties through current information reporting procedures. We support the effort for tax equity and tax compliance. However, we strongly oppose a withholding tax on payments of interest and dividends. A withholding plan would be even more complex and burdensome than is now perceived. Recordkeeping requirements would be enormous and heavy additional costs would be imposed on commercial banks. Commercial banks now file numerous information returns with the Internal Revenue Service on payments of interest and dividends. Large banks, such as ours, provide such information on magnetic tape. This increases the capabilities of the Service to match information reports with tax returns. If payments of interest and dividends are not being reported by the recipients, as is asserted, the government should allocate funds to improve information reporting and enforcement and collection procedures as they relate to recipients of interest and dividends. If the government's loss of revenue on underreporting can be substantiated, then these monies would be well spent.

The imposition of a questionable withholding plan to increase governmental revenue could not be instituted without significant additional cost to the government.

SUMMARY

The relative federal tax burden of a commercial bank is higher than perceived. Therefore, the share of corporate income tax paid by commercial banks should not be increased by an alternative tax as currently designed. Since the benefit of tax-exempt interest to a commercial bank is exaggerated, municipal bond carrying costs should not be construed as an item of tax preference. In addition, it is equally unfair to impose a questionable tax withholding plan, the cost of which would be borne largely by commercial banks. We are pleased to have had the opportunity to express our views and would appreciate your consideration of them when these tax proposals are addressed.

Respectfully submitted,

JOHN L. STASKEVICH,
Vice President and Director of Taxes.

BANK BUILDING WEST,
Burlingame, Calif., April 13, 1982.

Hon. DAN ROSTENKOWSKI,
Chairman, House Ways and Means Committee, House of Representatives, Washington, D.C.

DEAR CONGRESSMAN: I was deeply disturbed to learn that the Administration has proposed to eliminate the use of the completed contract method of reporting income for tax purposes. In this era of high interest rates and inflation, it is difficult enough to make ends meet without being required to pay taxes on a contract before I have the cash, or know if the contract will yield a profit.

Using the completed contract method, Bank Building West has been able to meet its fair tax obligations as they become due. However, if Bank Building West is forced to start paying taxes immediately on contracts that are in a positive cash flow position while deferring deductions on contracts in a negative cash flow position, it will have to borrow money to finance tax payments. Few banks would be willing to loan money for tax payments. With the economy in its present condition, this new burden could well force Bank Building West out of business or severly restrict its business activities.

I hope you will closely scruntinize these proposals. They are poorly thought out and are not in the best interests of the American public.

Sincerely yours,

DOUGLAS F. BAKER, *President.*

[NOTE.—Letters identical to the above were received from Richard R. Larrabure, Vice President, Executive Sales, and H. Don Aste, Manager of Estimating.]

J. W. BATESON CO., INC.,
Dallas, Tex., March 29, 1982.

Re Completed contract method of tax accounting.

COMMITTEE ON WAYS AND MEANS,
House of Representatives,
Washington, D.C.

DEAR SIRS: We respectfully urge the Ways and Means Committee to retain the completed contract method of tax accounting.

Under the completed contract method, a construction company pays taxes after a project has been completed and accepted by the owner. That makes sense because prior to that time, a construction company can only estimate what the eventual profit might be.

In my 35 years experience with J. W. Bateson Company, Inc., I have found it impossible to accurately estimate the final profit or loss on a construction project before its completion. Typically, the unexpected occurs and reduces the anticipated profit. A construction company can incur losses resulting from fires, tornados, strikes, the bankruptcy of an owner, subcontractor or supplier, or any other unexpected event or underestimated cost. Thus, a tax accounting method other than the completed contract method will result in (a) more taxes being paid during the course of many contracts than the final taxable income, and (b) taxes being paid on some contracts that eventually end up with losses.

Most people do not realize that the profit margin in the construction industry averages between 1 percent and 2 percent of revenues. It is also not commonly understood that the owner traditionally holds back between 5 percent and 10 percent of the revenues on a construction project until after it has been completed to the owner's satisfaction. Thus, the retainage which is paid after the completion of a project and after acceptance by the owner is normally much greater than the profit earned by the construction company.

In all fairness, the construction industry should be taxed like a manufacturer—when the product is completed and has been accepted by the customer. The time it takes to produce our product adds to the business risk, and we should not be penalized with a tax prepayment before the project is finished. The Treasury proposals are tantamount to taxing unrealized profit in the inventory of a manufacturer.

All construction contracts that are awarded on a lump sum bid basis have a maximum amount that is payable. Nearly all negotiated contracts also have a maximum price that is guaranteed by the contractor. Therefore, a construction company normally must absorb the risk of costs resulting from unforeseen events such as fires, tornados, strikes, the bankruptcy of an owner, subcontractor or supplier, or any

other unanticipated or underestimated cost. These events could occur after a taxable profit had already been reported under the Treasury proposals.

The completed contract method has been used for 60 years. The timing of income recognition on the completed contract method is well established. Imagine the cost to both the Government as well as the construction industry over the next 20 years in establishing the proper timing for recognition of income under either of the methods proposed by the Treasury Department, i.e., the percentage of completion method or the progress payment method. Internal Revenue agents could indiscriminately propose innumerable adjustments under the percentage of completion or progress payment methods, even on contracts that eventually produce losses.

It is essential to the construction industry to retain completed contract tax accounting.

Sincerely,

JOHN A. WACKER.

STATEMENT OF GARDNER S. MCBRIDE, EXECUTIVE VICE PRESIDENT, BUILDING OWNERS AND MANAGERS ASSOCIATION INTERNATIONAL

SUMMARY

Our nation's current economic problems, especially recession and unemployment, have a significant effect on the commercial and residential segments of the real estate industry. The economic situation worsens when the real estate industry declines.

The office building industry in particular has suffered the consequences of rising operating costs despite high office occupancy rates. There will be a continuing increase in the need for office space in the coming years, particularly in the service sector of our economy. However, some present provisions in the Internal Revenue Code act as a disincentive to capital investment in the real estate industry.

With respect to the proposals of the Administration, BOMA urges that (i) the limitation upon the deductibility of construction period interest and taxes and (ii) the acceleration of the expiration of the energy tax credits be rejected. BOMA suggests as an alternative that the current limitation upon construction period expenses as well as the current energy tax credit expiration dates be repealed.

I. Introduction

I am Gardner McBride, the executive director of the Building Owners and Managers Association International (BOMA). BOMA is an association of over 5,000 owners and managers of commercial office buildings comprising nearly one billion square feet of space. In addition, our members own or manage residential rental property as well as other types of nonresidential real estate.

II. The state of the economy and the Office Building Industry

The United States is experiencing a period of high interest rates along with a deepening recession which has produced high unemployment and reduced capital investment in the commerical and residential segments of the real estate industry. The office building industry in particular has suffered the consequences of rising operating costs even though at the present time office occupancy rates are high relative to their levels of pre–1978.

I should note that about seventy percent of office space in the United States is concentrated in central cities.[1] Office buildings play a crucial role in the health and vitality of downtown areas, providing places of employment for central city residents as well as suburbanites. Therefore, continued construction of office buildings is vital.

Over the last twenty years, while employment in manufacturing industries in central cities remained relatively constant, employment in the government and service sectors increased dramatically. Government and service workers are office-space-oriented. Employment growth in the government and service sectors is a major determinant of office building construction. It has also been largely responsible for the total growth of new jobs in central cities. We project that in the coming years, there will be a continuing increase in employment in these sectors.

BOMA is concerned that two of the proposals of the Administration—expansion of Section 189 to all taxpayers and the accelerated expiration of all business energy

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[1] Bennett Harrison. Urban Economic Development. Washington, D.C.: Urban Institute. 1974; p. 13.

tax credits—are a disincentive to capital investment in the real estate industry which will retard needed construction of both new and replacement office buildings.

Since much office building construction occurs in the downtown areas, incentive given to construction will contribute to the revitalization of our urban cores and work to further some of this nation's important urban and social goals. If current incentives for real estate are repealed or limited, we are concerned that new office building construction proposals may be rejected in favor of competitive investments. This situation takes considerable time to correct itself in the office building industry since the amount of new office space proposed is often just a fraction of the total office space market. Office buildings generally take over three years to plan and build. Restricting capital availability only aggravates the traditional boom or bust cycle of the industry. Eventually, of course, rents rise high enough to favor office building investment, but in the intervening periods cities lose tax revenue and may be forced to reduce some vital municipal services. The members of the service-dependent urban population will pay part of the cost of these problems.

III. Administration's tax proposals

A. Construction period interest and taxes.—Section 189 of the Internal Revenue Code requires that a taxpayer other than a corporation (which is not a subchapter S corporation or a personal holding company) capitalize real property construction period interest and taxes over a 10-year amortization period. Because the 10-year period was phased in and did not become fully effective for commercial and industrial property until 1982, the full negative effect of this provision has not yet been seen by the real estate industry.

The effect of Section 189 is to drain capital from the real estate industry by denying individuals the right to deduct currently actual, out-of-pocket expenses as others are allowed to do. This inequitable treatment discourages investors from the development of real estate.

In addition, the additional capital required as a result of Section 189 increases the cost of development and forces either the rents to lessees or the prices to purchasers to rise.

Section 189 is particularly onerous today when interest rates are so high. It discourages entrepreneurs from entering into otherwise viable office building and other real estate developments or construction which reduces competition and increases prices.

Repeal of Section 189 will merely allow a dollar-for-dollar deduction of amounts actually paid as interest and taxes during the construction period. This will equalize the treatment of interest and taxes between real property business expenses and all other business expenses. Moreover, repeal will eliminate the current anomaly in the law which treats the income from real property investments as business income but denies expense treatment to the costs which generate that income.

The Administration has proposed extending this investment disincentive to all corporate taxpayers. In light of the adverse consequences discused above, we support the total repeal of the provision in order to equalize the treatment of interest and taxes between the real estate industry and other business endeavors, remove the current discrimination between individuals and corporations, and, finally, encourage investment in productive real property.

B. Business energy property tax credits.—Section 46 of the Internal Revenue Code, enacted by the Energy Tax Act of 1978 and modified by the Crude Oil Windfall Profits Tax Act of 1980, provides additional tax credits of 10 percent and 15 percent for investment in certain types of energy property. The majority of such are scheduled to expire on December 31, 1982, but several of the credits are scheduled to expire on December 31, 1985.

C. Energy conservation.—Energy conservation remains a major and essential national goal which cannot be met if energy conservation incentives are eliminated. Such incentives are necessary to correct past investment disincentives such as price and allocation controls and unfavorable tax policies.

Commercial buildings and facilities, including office buildings need expanded rather than contracted energy tax credits. The IRS has ruled that specially defined energy property such as automatic energy control systems is ineligible for the credit when installed in retail or office space, despite the fact that such systems produce major energy savings by substantially increasing the efficiency of heating and cooling equipment and that a large percentage of the nation's energy is consumed in commercial and office space.

Unfortunately, the Administration has proposed to repeal the credit for all energy property on December 31, 1892. BOMA urges Congress to reject this proposal and extend—and expand—the business energy credits to maintain the progress toward

conservation which has already occurred. In addition, BOMA urges the Congress to make clear that systems such as automatic energy controls which produce major energy savings are eligible for the credits when installed in office buildings. BOMA suggests that these changes would significantly improve the likelihood of achieving the national goal of energy independence. S. 1288, the Commercial Business Energy Tax Credit Act, which is now pending in this Committee, would accomplish these objectives. BOMA urges that the provisions of this bill be enacted.

GREAT FALLS, MONT., *April 5, 1982.*

Hon. DAN ROSTENKOWSKI,
Chairman, House Ways and Means Committee, House of Representatives, Washington, D.C.

DEAR CONGRESSMAN: A few days ago I read about testimony presented to your committee by Theodore Brophy, who was speaking for the Business Roundtable. The news articles said Mr. Brophy was testifying against some of President Reagan's proposals for minor adjustments in the huge tax breaks large corporations received from the tax cut bill Congress passed last year. Evidently Mr. Brophy told you that these proposals "would reduce business benefit from (last year's tax cut) by 40 percent, "and that some depressed industries, such as steel would end up paying more taxes than if the 1981 tax cut had never been enacted.

Mr. Robert Malott, of FMC Corp, said Reagan's proposal "will—devastate a major effort currently underway to retool America's basic industries."

I would like to tell these gentleman to stop trying to "con" the Congress and the American people.

Last year, not knowing much about tax policy, I tended to be supportive of efforts to help business bring our plants and equipment up to date. I serve on an Economic Growth Council that is trying to promote economic development in my community. I am not anti-business.

But when a neighbor, who is retired, tells me that three doctors have told her husband that he should have surgery to see if a growth is cancerous; and he decided against it because he doesn't have whatever he has to pay to get medicare started and they couldn't afford the additional monthly doctor bills for what medicare would not pay—then I began wondering if all these tax breaks for business were fair or justified, or worth the cost to the rest of us. After doing a little research, I definitely feel they are neither fair nor justified, and certainly not worth the cost being paid by my neighbor.

The steel industry lost whatever sympathy I may have had for it when I found out that the purchase of Marathon Oil will mean that planned improvements by U.S. Steel at their Edgar Thompson Mill and new furnaces for their Homestead plant have been shelved. U.S. Steel has publicly and rhetorically proclaimed its commitment to saving the industry. It mobilized legislative and popular support for a series of measures it claimed would ensure steel development. Meantime, it has consistently chosen to increase its holdings in other non-steel related enterprises and to defer modernization of its steel making facilities. During the years when profits were high, U.S.S. paid generous dividends to shareholders instead of reinvesting in new technology. It seems to me that the steel industry is a victim of poor, short-sighted management decisions; and as a taxpayer, I resent tax policies where we pay for those poor decisions.

I have not seen any major effort underway to retool America's basic industries. I do see a lot of "diversification" and mergers.

If President Reagan's proposals would reduce business benefit from last year's tax cut by 40 percent, I think that would be a positive step in the right direction.

There is no question that some tax payers deserved a tax break. Unfortunately, they are not the ones who really are getting one.

My research indicated the following:

	Percent increase	
	1972–80	In excess of inflation
Inflation	79	—
Median family income	79	0

	Percent increase	
	1972–80	In excess of inflation
Average hourly earnings	80	1
Personal dividend income	126	47
After-tax corporate profits	174	95
Corporate executive pay	178	99
Personal interest income	217	138

And then I look at who got tax cuts and I find that it was mainly individuals earning over $50,000/year (especially those with incomes over $200,000/year) and that, as a share of total federal receipts, corporate income taxes will decrease by 43 percent between 1980 and 1987.

In commenting on the tax cut bill, David Stockman has said, "The greed level, the level of opportunism, first got out of control". Evidently not much has changed. I urge you and the committee to carefully examine the tax bill passed last year and eliminate the inequities. Please do something that will help small businesses, who create most of the jobs—and let the oil, chemical, and mining companies who are the primary beneficiaries of the existing tax policies, take care of themselves and pay their fair share. If we want to encourage "retooling of America's basic industries", then write the law so that will be what happens. Don't just give huge tax breaks and leave it to corporations to decide to do things that will increase productivity. Experience shows that often they'll use the money for diversification and other non-productive things.

Big business has got to accept the fact that the American people will not accept record high unemployment, unaffordable health care, hungry children, cuts in education and job training programs to satisfy their greed.

Members of Congress had better examine what people like Mr. Brophy and Mr. Malott say and what business is doing more critically. We're being "taken for a ride"—and average people, like me, are beginning to realize it. I've heard more people say they didn't think it made any difference whether they voted or not, but they sure found out it did. Farmers have said they could take 20 percent higher taxes easier than 20 percent interest rates. People have said, "As bad as things were with Carter, at least we were working".

We made a terrible mistake with the budget and tax cuts last year. Let's admit it and turn it around before we do anymore damage.

Sincerely,

MAUREEN BURESON,
Network Congressional District No. 2 Contact.

CENTEX CORP.,
Dallax, Tex., March 26, 1982

WAYS AND MEANS COMMITTEE,
U.S. House of Representatives,
Washington, D.C.

DEAR SIRS: We would like to submit this letter as written testimony in the Ways and Means Commitee Hearings this week on the Completed Contract Method of Tax Accounting.

Centex Corporation is a diversified company with annual revenues of over one billion dollars. Our largest business is as a general contractor in the construction industry, where our annual revenues are presently about $500,000,000.

Today the construction industry is facing difficult times. The amount of construction work is headed for a decline due to the high level of interest rates and the economic recession.

We are strongly opposed to the recent proposal of the Treasury Department to eliminate Completed Contract Tax Acounting for the construction industry.

The Completed Contract method has been used in the construction industry for over 60 years. It has stood the test of time, and there is no need to discard it.

It is well known in the construction industry that the eventual profit on a construction project is generally much lower than the retainage (normally 5 percent to 10 percent of the total price) which the owner holds back until the project has been completed. As a result, a construction company generally does not collect its profit until after the project has been finished and accepted by the owner.

We object to the Treasury Department proposal on Percentage of Completion Tax Accounting, because we know that a construction company can not accurately determine the amount of profit or loss on a construction project until it has been substantially completed, and accepted by the owner.

Until that point, a construction company is vulnerable to the adverse impact of factors beyond its control, including: weather delays, strike delays, increases in costs due to inflation, and the failure of other parties, such as a subcontractor, a supplier, or an owner to perform on a timely basis, due to bankruptcy or otherwise.

The risks in the construction industry are increased because construction projects have lump sum prices or guaranteed maximum prices. All the construction contracts we obtain throuh competitive bidding (including all of our Government contracts) have a lump sum bid price. The other contracts which we obtain on a negotiated basis almost always have a guaranteed maximum price.

A construction company is 100 percent at risk for any cost overruns in excess of the lump sum bid price or the guaranteed maximum price. We may not be aware of cost overruns or their magnitude until the latter stages of a project.

Percentage of Completion Tax Accounting would result in a tax on an "estimate" of the eventual profit, before the amount of profit is actually known and before it is actually received via the retainage. In our opinion, that would be unfair.

The IRS auditors would have a field day with the Percentage of Completion method. With the benefit of hindsight, they could propose higher taxes for any job on the basis of the percentage of completion claimed or the amount of profit estimated by the taxpayer at the end of each year.

We also object to the Treasury proposal on Progress Payments Tax Accounting, because it would be a tax on cash flow, the first such instance we are aware of in the United States. There is no correlation between the ups and down of the cash flow during the course of construction and the eventual profit or loss on the job.

The Progress Payments method would cause a company to pay taxes during the course of a job that would often exceed the eventual profit on the job. In fact, the Progress Payments method would tax a job that had a positive cash flow, even if it were expected to be unprofitable by the time it were completed.

For the above reasons, we urge the Ways and Means Committee to retain Completed Contract Tax Accounting for the construction industry.

Sincerely,

FRANK M. CROSSEN,
Chairman of the Board.

STATEMENT OF THE CHEMICAL MANUFACTURERS ASSOCIATION

The Chemical Manufacturers Association (CMA) would like to express its views on the Administration's current income tax proposals, particularly the proposal for an alternative minimum tax on corporations. We believe that the imposition of additional taxes at this time will reduce the effectiveness of the Administration's economic program and slow the recovery from the current recession. Furthermore, we believe that the concept of a minimum tax is not good tax policy.

CMA is a non-profit trade association having 185 United States company members representing more than 90 percent of the production capacity of basis industrial chemicals within this country. The chemical industry is vitally affected by changes in tax policy that impact on capital formation and exports; the proposed tax changes would do both.

Economists are in general agreement that taxes should not be increased during periods of economic slowdown or recession. The present recession in particular appears to be a reflection of the lack of attention paid over many years to the need to eliminate the bias in our tax system against capital formation. This bias was finally dealt with in the Economic Recovery Tax Act of 1981. We believe that until the economy has had a fair chance to respond to the economic program adopted last year, no new tax measures should be enacted that are inconsistent with that program. The proposed alternative minimum tax, which is a permanent tax, is inconsistent with that program and is an unwise response to a temporary problem.

The Administration proposes to repeal the existing add-on minimum tax effective January 1, 1983, and replace it with the alternative minimum tax. Under the proposal, a corporation would be required to pay the greater of its regular income tax or the alternative tax equal to 15 percent of its alternative tax base in excess of $50,000. The alternative tax base consists of regular taxable income plus certain tax preferences, and the alternative tax cannot be reduced by the investment tax credit.

The tax preferences proposed by the Administration to be included in the alternative tax base are the following:

(a) Percentage depletion in excess of the year-end adjusted basis of the property;

(b) Accelerated depreciation on real property in excess of that allowable under the 15-year straight-line method;

(c) Amortization of certified pollution control facilities;

(d) Reserves for losses on bad debts of financial institutions in excess of reserves allowable on the basis of their experience;

(e) Intangible drilling costs in excess of amounts allowable had they been amortized over 10 years;

(f) Mining exploration and development costs in excess of those allowable under a 10-year amortization schedule;

(g) Lessor's leasing benefits which are in excess of net cash investment amortized on the straight-line basis over the term of a safe-harbor lease;

(h) Deductions for interest on debt to carry tax-exempt securities;

(i) Deferred DISC income;

(j) Shipping income deposited in capital construction funds or construction reserve funds;

(k) Amortization of motor carrier operating rights deductible under Section 226 of the Economic Recovery Tax Act of 1981;

(l) Original issue discount interest deductions in excess of amounts that would be deductible under a constant interest rate bond;

(m) Current deductions of certain indirect costs incurred with respect to long-term contracts entered into before September 25, 1981; and

(n) Amortization of child care facilities.

There have been no statements by the Administration that the so-called "tax preferences" have not been effective in doing what they were designed to do. The expressed rationale for the minimum tax is simply to ensure "that all profitable corporations pay their share of tax." (Statement of Donald T. Regan before the House Committee on Ways & Means, February 22, 1982).

CMA strongly believes that the concept of a minimum tax serves no purpose in corporate taxation and disrupts both long-term and short-term investment planning. If certain industries or corporations are not paying what is perceived to be a fair share of tax, or if cetain tax preferences are no longer needed, then those problem areas should be addressed directly. A minimum tax should not be substituted for a careful analysis of any defects in the underlying system of taxation. Once established, it is too easy to raise and lower the rate of minimum tax rather than to address the merits of particular tax policy issues.

If the minimum tax is enacted, corporate treasurers and tax managers will have to plan future corporate activities in light of both the regular income tax and the minimum tax. In certain situations, the minimum tax might constitute a sufficient disincentive to override investment plans encouraged in the regular corporate income tax system. Decisions to invest in new plant and equipment could be adversely affected.

An additional problem with the minimum tax is that it is not targeted toward any particular group of taxpayers. It operates indiscriminately against any taxpayer who runs afoul of its provisions, and if any group of taxpayers is affected more than others, that group is the very group—capital intensive industries in need of plant modernizations—that Congress and the Administration tried most to help last year.

The investment tax credit will not be allowed as a credit against the minimum tax. This disallowance substantially reduces an incentive designed to promote capital formation at precisely the time when the nation needs a sharp increase in capital spending. It took a number of years before the nation's tax policy makers became convinced that a permanent investment tax credit represented sound economic policy. During that time the business community consistently made one basic point: that business needed certainty over a term of years in the tax policy regarding new investment and that the investment credit would work if business could count on its existence and amount at the time of making long-term investment decisions. After finally succeeding in making the investment tax credit a permanent 10 percent, we find in the minimum tax a proposal that would substantially eliminate the credit for those companies that may be liable for the minimum tax. To us, this is not sound tax policy.

Deferred DISC income has been designated a tax preference for purposes of the minumum tax. It is inconceivable that after a number of years of United States representatives arguing before representatives of the General Agreement on Tariffs and Trade (GATT) that DISC was not a subsidy or a system of taxation preferential

to exports, the present Administration would in its proposal include DISC as a tax preference.

It is clear that the United States taxes export income more heavily than do many developed nations. It is also clear that high United States interest rates and economic conditions abroad have combined to markedly slow exports from this country. Most authorities who have seriously studied United States trade policy have concluded that DISC is not a sufficient tax export policy and that the United States should do more to encourage exports. Moreover, it should be noted that in 1981 the chemical trade surplus declined to $11.3 billion from the 1980 level of $12.2 billion. In view of this significant decline, it would be inappropriate and self-defeating to reduce DISC benefits at this time.

Thus, instead of doing more to encourage exports, the Administration would take away, under certain conditions, part of the DISC benefit for exporters. This is a perfect illustration of how a minimum tax operates indiscriminately.

Another illustration that a minimum tax is not a sound tax policy is the inclusion as a tax preference of certain safe harbor leasing benefits. The safe harbor leasing provisions were enacted little more than six months ago because it was believed that those provisions represented desirable policy. The inclusion of certain leasing benefits in the minimum tax base undermines a carefully designed tax policy. In the future, a lessor would have to examine its potential liability for minimum tax over the period of the lease.

We do not intend to suggest in this statement what the tax policy on safe harbor leasing should be. What we do say is that if the leasing provisions are perceived as a problem, the problem should be considerd on its merits. A minimum tax applicable to the entire business community is not a proper response.

We believe that other proposals of the Administration are also ill-advised. Energy tax credits were enacted in the law in 1978 and 1980 because of an obvious long-term need to encourage the conservation of energy and the develpoment of new energy sources. That need still exists, and the present level of crude oil in world markets does not obviate that need. Energy tax credits, if anything, should be extended, not cut back. In any event, where commitments on energy projects have been made based on existing tax incentives and effective dates, those commitments should not be affected by new tax law changes.

Additionally, the Administration's proposal that corporate estimated tax payments be increased from 80 to 90 percent of current year liability is an attempt to squeeze additional revenue at an undue administrative cost to corporations. This administrative burden is as severe as some of the non-tax regulatory measures that are being examined for possible elimination by this Administration on the ground that business is unduly burdened. In any event, if corporations must pay in close to 100 percent of their current year's tax liability in order to avoid a penalty, they should be paid statutory interest if they happen to overpay, and that interest should accrue from the date of overpayment rather than the date of filing of the tax return. In addition, section 6425(b)(3) of the Internal Revenue Code should be amended to allow tentative overpayment adjustments of any amount.

The various elements of the Administration's proposals clearly show an attempt to raise immediate revenue at whatever cost to sound tax policy. CMA urges this Committee to reject the Administration's proposal for additional tax revenues and in particular for an alternative minimum tax. The short-term need for additional revenues is not an appropriate reason to adopt such a permanent and disastrous tax policy.

OFFICE OF THE MAYOR,
Chicago, Ill., April 15, 1982.

Re Administration's proposal on industrial development bonds.

Hon. DANIEL D. ROSTENKOWSKI,
Chairman, House Ways and Means Committee, 2111 Rayburn Building, Washington, D.C.

DEAR REPRESENTATIVE ROSTENKOWSKI: On February 26, 1982, the Treasury Department released its General and Technical Explanation of Tax Revisions and Improved Collection and Enforcement Proposals ("Tax Revision Proposals"). The Tax Revision Proposals would restrict or eliminate the use of industrial development bond financing in the City of Chicago. Since the House Ways and Means Committee is considering these tax revision proposals, I would appreciate your including my comments on behalf of the City of Chicago in the record of the Committee's hearings.

Industrial development bond financing has been very important to the economy of the City of Chicago. Since 1977, Chicago has issued small issue (§ 103(b)(6)) bonds in the amount of $111 million benefiting 62 small industrial and manufacturing concerns. The large majority of the beneficiaries have been small industrial or manufacturing businesses which otherwise would have little or no opportunity to obtain financing for the improvements which have been built under the industrial development bond program.

It is estimated that the small issue bonds have made possible the acquisition and construction of $70 million worth of industrial and manufacturing facilities with the consequent increase in the City's tax base. Moreover, it is estimated that 15,000 jobs have been retained or will be created as a result of this program.

Plans are now well under way to take advantage of the industrial development bond provisions for exempt quasi-public facilities (§ 103(b)(4) facilities). We have already embarked upon a major redevelopment of Chicago-O'Hare International Airport, with an estimated cost of one billion dollars. We intend to finance the initial and some later phases with § 103(b)(4) financing.

Several aspects of the Tax Revision Proposals would have the effect of making industrial development bond financing prohibitively expensive for issuing cities like Chicago and for the beneficiary industrial concerns.

The proposed requirement that the issuing city contribute one percent of the face amount of the bonds from its own funds is an unnecessary financial burden. In the past, the cost of the facilities financed throught industrial development bonds have always been borne by the persons who will be using them in their trades and businesses. Furthermore, the Tax Revision Proposals would require that issuance costs incurred by the issuing city could not be reimbursed by the beneficiary. All such costs should properly be borne by the person for whom the bonds are issued and who will benefit directly from the project for which the funds are spent. In this era of increasing pressure on local taxation and of decreasing federal contributions to localities, these increased costs could be sufficient to reduce or eliminate a city's participation in the industrial development bond program.

Other provisions of the Tax Revision Proposals make industrial development bonds prohibitively expensive to the beneficiary. Perhaps most damaging is the proposals to restrict the accelerated cost recovery otherwise possible under the Economic Recovery Tax Act of 1981. This is a penalty applying to beneficiaries of industrial development bonds which would not apply in other circumstances.

The Tax Revision Proposals would require that industrial development bonds be issued in registered form and impose greater arbitrage restrictions than would ordinarily be applicable to tax-exempt bond proceeds. These proposals would have the effect of increasing the beneficiary's cost, and, in fact, would doubtless make industrial development bond financing prohibitively expensive for smaller industrial concerns.

I recognize that the Tax Revision Proposals are a response to the abuses of industrial development bond financing which have occurred from time to time. Generally, these abuses have come from large commercial companies, such as fast food franchisers or large retailers, who have taken advantage of industrial development bonds to finance retail outlets. These abuses have not, however, occurred in Chicago, where commercial beneficiaries have been infrequent users of the City's industrial development bonds. A principal problem with the Tax Revisions Proposals is that they fail to address these abuses. Rather than restricting large commercial users of industrial development bonds, the Tax Revision Proposals tend to make all industrial bond developments more expensive, both for issuers and beneficiaries, and to eliminate the small industrial beneficiary.

Legislation should properly address the abuses of industrial development bond financing, but should do so in a manner focused on the problem, rather than restricting industrial development bonds, generally. The administration's Tax Revision Proposals should not be enacted because they would eliminate a program which has been effective in the City of Chicago in encouraging new construction and new jobs and which we are depending on for financing a major O'Hare development.

Very truly yours,

JANE M. BYRNE.

CHICAGO ASSOCIATION OF COMMERCE AND INDUSTRY,
Chicago, Ill., April 15, 1982.

Mr. JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, D.C.

DEAR MR. SALMON: The Chicago Association of Commerce and Industry wishes to present its views on certain provisions of the Administration's revenue enhancement proposals. The Chicago Association of Commerce and Industry is a voluntary organization of business and professional leaders working together to promote the commercial and industrial growth of Metropolitan Chicago and to foster civic improvements that benefit the general welfare of all who live and work in the area. The area includes Cook, McHenry, Lake, Kane and Will Counties in Illinois and Lake and Porter Counties in Indiana. The Association is the principal representative of the Chicago area business and industrial community and represents 5,500 business and 12,000 individual members, who employ over 1.2 million workers.

The provisions on which the Association wishes to present its view are those relating to a corporate minimum tax, the completed contract accounting method and corporate tax payment acceleration.

CORPORATE MINIMUM TAX

The Administration proposes that the present corporate minimum tax be replaced by a new alternative corporate minimum tax. The proposed corporate tax would apply to so-called corporate profits as measured by regular taxable income plus a list of 14 special deductions. The special deductions would include all of the deductions covered by the existing corporate minimum tax (percentage depletion in excess of cost depletion, accelerated depreciation in excess of straight-line depreciation on certain properties, etc.) plus a number of new items including intangible drilling costs, lessor's leasing benefits, deferred DISC income, etc.

The Association strongly opposes the proposed broadening of the existing corporate minimum tax. Congress has chosen (after very careful study) to provide each of the benefits afforded by the special deductions. All of the special deductions were carefully considered by Congress and reflect a policy that the benefits provided by such deductions are consistent with a sound tax system. The proposed corporate minimum tax would operate in direct conflict with such policy by arbitrarily taxing some corporations on a portion of such special benefits.

It has been argued, in support of a minimum tax, that every taxpayer should contribute some minimum amount to the public revenues. Such an argument may be politically attractive. However, the Association submits that the argument is not sound in principle, at least in the case of corporations. The Association urges the Congress to reject the proposed corporate minimum tax because it is fundamentally inconsistent with the sound policy purposes behind the special deductions.

COMPLETED CONTRACT METHOD OF ACCOUNTING

For many years, taxpayers have been allowed to defer recognition of income on long-term contracts under the completed contract method. A taxpayer who elects to use the completed contract method of accounting (thereby deferring the recognition of income) must also defer the direct costs associated with the earning of such income.

The Administration proposes that the completed contract method of accounting be repealed and that taxpayers be required to use either the percentage of completion method or the progress payment method of accounting for long-term contracts.

The Association is opposed to a complete repeal of the completed contract method of accounting. The committee has received testimony from many companies on this matter demonstrating, among other things, that the flow of funds on long-term contracts usually lags behind the flow of income. Early taxation of profits would work a hardship on many taxpayers who now utilize the completed contract method of accounting because of the lag in cash flow. The Association understands that there may be some areas in which the completed contract method is subject to abuse. However, the Association urges Congress to develop a solution which is tailored to deal with abuse cases rather than cause the inequities which would result from blanket repeal of the completed contract method.

ACCELERATED CORPORATE PAYMENTS

The Administration proposes a number of amendments which would accelerate the payment of corporate income taxes. The Association endorses the principle that

corporate tax payments should be made on a more current basis. However, the Association recommends that Congress reexamine the present penalty imposed on underestimation of tax, and its support for this proposal is subject to such a reexamination. The Association urges the Congress to change the present penalty for underestimation of tax to a deductible interest charge. If corporate payments are required on a more current basis, there is an increased risk that taxpayers will innocently underestimate their tax liabilities. A non-deductible penalty at the present rate of 20 percent is the equivalent of an onerous interest charge of nearly 40 percent.

The Association further recommends that the penalty provisions for underpayments of estimated tax be reexamined generally and that the method for computing interest also be reexamined. The present system can result in either too high or too low a rate of interest, substantially out of line with the current rapid fluctuations in interest rates, for a period of a full year. The Association believes that the interest rate can be adjusted under a more equitable formula and more frequently than under present law without imposing undue burdens on the tax collecting system.

Cordially,

SAMUEL R. MITCHELL, *President.*

CITIBANK, N.A.,
New York, N.Y., April 16, 1982.

HON. DANIEL ROSTENKOWSKI,
Chairman, Ways and Means Committee, House of Representatives, 2111 Rayburn House Office Building, Washington, D.C.

DEAR CHAIRMAN ROSTENKOWSKI: Citibank shares the concerns of the business community and the public about the dilemma which confronts the Administration and Congress in attempting to solve the extremely complex problem of constructing a budget for the 1983 fiscal year. In late February, the Administration released a series of tax revision and tax collection proposals which are intended to raise revenues to reduce substantial estimated deficits. Thus far, the Administration's proposals have not been reduced to legislative form. Therefore, without the necessary detail, it is somewhat difficult to assess the full impact of these proposals. Other proposals, some apparently similar but more far-reaching than the Administration's proposals, are being discussed in Congress.

Citibank takes this opportunity to comment briefly on two of the proposals which are under consideration.

ALTERNATIVE CORPORATE MINIMUM TAX

The Administration proposes to repeal the "add-on" minimum tax on tax preferences, which Congress enacted in 1969, and to replace it with an alternative corporate minimum tax which includes a more extensive list of tax perference items upon which the new minimum tax would fall. The concept of a minimum tax has been criticised by many commentators with considerable justification on the grounds that it imposes a penalty on taxpayers who elect to use, or who are required by law or economic considerations to use, tax incentive provisions of the Internal Revenue Code which have been adopted by Congress on sound economic grounds. As such, a minimum tax, because of the manner in which it earmarks "items of tax preference" on unanalytical basis, fails to properly assess the economic value of these provisions as they were originally intended by Congress.

A minimum tax is highly questionable if not poor tax policy. In the first instance, it fails unevenly and unfairly among different segments of the business community, depending upon who is "tagged" with one or more items of tax preference. The minimum tax process has a creeping quality, as we have seen since this concept was first introduced in 1969, i.e., the list of tax preference items has increased over the last twelve years and would indeed jump forward under the various proposals which are new being considered.

The proposed alternative corporate minimum tax as it has been announced by the administration, and in apparently more extensive forms being considered by Congress, would reduce many of the economic incentive provisions which were enacted under ERTA-81 for the purpose of encouraging capital formation and stimulating business activity in general. Thus, Citibank is concerned about the economic effects of the entire alternative minimum tax, as it is perceived under the Administration's proposal, as well as under proposals which appear to be pending in Congress.

We wish to comment briefly on two aspects of the minimum tax. The proposal would treat as an "add-back" item of tax preference the interest on bank indebtedness which would be allocated to bank holdings in State and local governmental ob-

ligations. Our principal concern with this provision is that it would have a direct and immediate impact on the cost of borrowing by State and local governments to fund their public purpose projects. On the basis of our preliminary estimates, this proposal would raise borrowing costs for State and local governments between 1.5 and 2.0 percent, and perhaps even more, depending upon a number of factors which cannot be properly assessed at this time. This would come at a time when State and local governments are seeking financing to replace reductions in Federal programs.

Citibank is also concerned about possible effects of the proposed minimum tax on the creditability of foreign taxes. Any limitation on the ability of American businesses to claim full credit against taxes paid to foreign jurisdictions would introduce a proportionate level of unrelieved double taxation. More importantly, in a broad economic sense, limiting the foreign tax credit would diminish the ability of American businesses to compete in the foreign markets. This would have a negative impact on U.S. exports, export related jobs, and the U.S. balance of payments. In the case of banks, their ability to compete with foreign banks in international lending would be diminished.

WITHHOLDING-AT-SOURCE ON INTEREST AND DIVIDENDS

Withholding-at-source as a tax collection device has come before the Congress a number of times since 1960, and three times since 1970. Each time it has been considered by Congress, it has been resoundingly defeated, and for good reason. The tax costs to business and financial intermediaries would significantly offset anticipated revenue gains. The administrative complexities of withholding, both for the business sector and the government are enormous. More importantly, the number of individuals who would be adversely impacted by withholding, who have little or no tax liability, is unjustifiable under any withholding scenario.

We enclose for the Committee's consideration a memorandum relating to Congressional policy in connection with bank interest deduction question under Section 265(2) of the Internal Revenue Code. It has been the policy of Congress for more than 60 years not to apply the interest deduction prohibition to banks because of the adverse impact on the market of State and local obligations.

Yours very truly,

JOHN F. ROLPH III,
Vice President, Tax Legislation.

Enclosure.

Summary of the Legislative History and Administrative Interpretations of Section 265(2) Relating to Banks

A. LEGISLATIVE HISTORY

The statutory antecedents of Section 265(2) of the Internal Revenue Code of 1954 go back to the Revenue Act of 1917. As early as 1921, Congressional debates made it clear that the interest deduction prohibition did not apply to banks.

Although Congress over the years amended or considered amendments to the interest deduction prohibition under these Code provisions, it was clear that banks were not intended to be covered by these provisions.

The language ". . . indebtedness incurred to continued to purchase or carry obligations . . ." was added to the provision under recodified Section 23(b) of the Revenue Act of 1928. However, it was clear that this language was construed not to apply to banks.

When the Revenue Act of 1934 was under consideration, the Committee on Ways and Means proposed amendments to "tighten up" the interest deduction prohibition, including a proposal to remove the "bank exemption". The Senate Finance Committee opposed the House amendment on the ground that it would "seriously interfere with the marketing of government securities, which are bought for the most part by banks and financial institutions, and also present grave administrative difficulties". The Conference Committee adopted the Senate amendment restoring the provisions of existing law (Section 23 (b)) with the result that banks were not made subject to the interest deduction prohibition.

This provision was again discussed on the House floor in 1935, with the conclusion that the provision did not apply to indebtedness incurred by banks in paying interest on deposits.

Section 23(b) of the Revenue Act of 1928 was incorporated into the Internal Revenue Code of 1954, without change. This provision was redesingated Section 265(2) under the Internal Revenue Code of 1954, without substantive changes.

Section 265(2) was amended under the Revnue Act of 1964 to make special provision for obligations issued by face-amount certificate companies. In adopting this provision, the Senate Finance Committee noted that ". . . the general banking business is not subject to this provision since this indebtedness is not considered to be incurred or continued to carry tax-exempt obligations".

The House Committee on Banking and Currency in 1966 considered legislation pertaining to competition for savings and time deposits. At Committee hearings on this issue, the Treasury Department expressly stated that in view of its legislative history, Section 265(2) did not apply to commercial banks.

IRS AND TREASURY DEPARTMENT INTERPRETATIONS OF SECTION 265(2)

Over a period of nearly 60 years, the Internal Revenue Service and the Treasury Department issued rulings and policy guidelines which consistently reflected Congressional intent with respect to the non-applicability of Section 265(2) and its predecessors to banks.

The first IRS published position, issued in 1924, stated that indebtedness incurred by a bank through the acceptance of deposits is not incurred for the purpose of purchasing or carrying tax-exempt securities. An IRS opinion published in 1925 stated the same conclusion.

In 1924, the interest deduction prohibition was applied to dealers in investment securities in a Public Ruling of the Bureau of Internal Revenue; however, this position was held not to apply to commercial banks.

The next published position of the IRS was issued in a 1961 Revenue Ruling which held that Section 265(2) did not apply to interest paid on bank deposits, as such deposits did not constitute "indebtedness incurred" for the purchase or carrying of tax-exempt obligations.

The first IRS ruling which disallowed the deduction of bank interest expense under Section 265(2) involved an unusual "back-to-back"transaction where under a bank issued certificates of deposit under an agreement with a State government to purchase a like amount of the State's tax-exempt obligations. However, because the IRS had not previously addressed this factual situation, this Ruling was made prospective in application.

In 1967, the IRS ruled that the Section 265(2) prohibition did not apply to interest expense incurred by a bank in Federal Funds Transactions or in transactions involving short-term loans from Federal Reserve Banks to meet reserve requirements imposed by the Federal Reserve Board.

In 1970, the Treasury Department issued guidelines (Rev. Proc. 70-20) which stated that interest paid by banks on short-term indebtedness would not be disallowed under Section 265, absent a direct connection between the indebtedness and investments in tax-exempt obligations. The Treasury guideline states that the application of the interest deduction prohibition to banks "would seriously interfere with the marketing of government securities".

In a 1978 Revenue Procedure, the Treasury applied the principals of the 1970 guidelines to Treasury tax and loan accounts held by banks, which were collateralized by State and local or U.S. obligations, holding that Section 265(2) did not apply to the situation.

In 1980, Treasury issued Rev. Proc. 80-55, which would have denied bank interest deductions on State and local deposits which were collateralized by State and local obligations (a majority of States required the pledging of such obligations). Rev. Proc. 80-55 was withdrawn as a result of strong protests from Members of Congress who stated that this position was contrary to Congressional intent.

ADMINISTRATION PROPOSAL TO APPLY ALTERNATE CORPORATE MINIMUM TAX TO BANK INTEREST DEDUCTIONS ALLOCABLE TO HOLDINGS OF STATE AND LOCAL TAX-EXEMPT OBLIGATIONS

The Administration has proposed to repeal the present add-on minimum tax, effective January 1, 1983, and to replace it with an alternative tax applicable to corporations. One of the new "add-back items" of tax applicable to corporations. One of the new "add-back items" of tax preference which would be included in the alternative minimum tax base is that portion of a bank's interest deductions which would be allocated to its holdings in tax-exempt obligations.[1]

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[1] Under Rev. Proc. 72-18, infra, interest on indebtedness attributable to tax-exemt obligations is subject to an allocation rule where the use of borrowed funds cannot be directly traced. The

Continued

The deductibility of interest on borrowings to purchase tax-exempt obligations is governed by Section 265(2) of the Internal Revenue Code. IRC Sectin 265(2) generally disallows a deduction by a taxpayer for interest on indebtedness incurred or continued to purchase or carry tax exempt obligations. Bank indebtedness has generally been deemed *not* to be incurred to purchase or carry tax-exempt obligations. Thus, Section 265(2) generally has not been applied to banks.

The Administration proposal to treat the interest deduction on bank indebtedness as a preference item under the alternative minimum tax is contrary to the legislative history of Section 265(2) and long-standing legal and administrative precedents.

Throughout the development of Section 265(2) and its predecessor sections since 1917, Congress has repeatedly recognized that extending the interest deduction prohibition to banks would substantially disrupt the existing market for tax-exempt securities and seriously impact states and municipalities in their ability to raise public funds. Indebtedness on which banks pay interest is usually in the form of time deposits, Federal Reserve Bank loans, borrowings from other banks through the purchase of federal funds, direct inter-bank loans and repurchase agreements. The purpose of the borrowing in each case is to provide banks with funds for loans, or to replace withdrawn deposits, deposits being the primary source of bank funds available for lending.

The disallowance provision of IRC Section 265(2) reads in part as follows:

No deduction shall be allowed for—(2) Interest—Interest on indebtedness *incurred or continued* to purchase or carry obligations the interest on which is wholly exempt from the taxes imposed by this subtitle . . . (emphasis supplied).

In the ordinary course of a banking business, bank indebtedness has no direct relation to a bank's investment in tax-exempt obligations. Banks do not incur indebtedness for the purpose of purchasing or carrying tax-exempt obligations. This has been the position of Congress, the U.S. Treasury, and the courts.

Although IRC Section 265(2) does not expressly exclude commercial banks from its operation, it is clear from the legislatve development of Section 265(2) that Congress never intended to deny banks a deduction for interest paid on bank deposits and other typical forms of bank indebtedness.

LEGISLATIVE HISTORY OF SECTION 265(2)

The original limitation on the deductibility of interest expense related to tax-exempt securities was provided by the Revenue Act of 1917 in Section 1201(1). An individual was allowed a deduction for "all interest paid within the year on his indebtedness except on indebtedness incurred for the purchase of obligations or securities the interest upon which is exempt from taxation as income under this title." Section 1207(1) and 1207(2) contained the corresponding provisions for domestic and foreign corporations. The Senate Finance Committee report stated "that no exemption be allowed for interest upon indebtedness incurred for the purchase of obligations or securities from which is exempted from income taxation." S. Rep. No. 103, 65th Cong., 1st Sess. 20 (1917).

Sections 214(a) and 234(a)(2) of the Revenue Act of 1918 provided that individuals and corporations were allowed a deduction for "all interest paid or accrued during the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities . . . the interest upon which is wholly exempt from taxation under this title as income to the taxpayer." Congress was concerned apparently with the difficulty in administration resulting from the limitation of the 1917 provision requiring a direct relationship between the indebtedness and the purchase of tax-exempt securities and broadened the statute to cover obligations incurred "or continued" to purchase "or carry" tax-exempt securities. See H.R. Rep. No. 767, 65th Cong., 2d Sess. 10 (1918).

The House Ways and Means Committee had proposed an amendment which would have allowed the deduction of all interest paid in excess of the amount of interest received free from income tax. The House amendment was premised upon the apparent administrative difficulty in determining the purpose for which indebtedness was incurred. H.R. Rep. No. 767, 65th Cong., 2d Sess. 10 1918. The Senate opposed the House amendment because it would allow taxpayers to obtain loans for purchases of wholly exempt securities and then deduct interest paid on such loans

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amount of interest to be disallowed is determined by multiplying the total interest by a fraction, the numerator of which is the average amount during the taxable year of the taxpayer's exempt obligations and the denominator of which is the average amount of the taxpayer's total assets minus any indebtedness the interest on which is not subject to disallowance.

from taxable income. S. Rep. No. 617, 65th Cong., 3d Sess. 6-7 (1919). The House receded in conference. H.R. Rep. 1037, 65th Cong., 3d Sess. 49 (1919).

Sections 214(a)(2) and 234(a)(2) were amended by the Revenue Act of 1921 only to limit the exception for certain United States obligations issued after September 24, 1917. The House again tried to amend the provision to limit the deduction for interest paid on indebtedness by permitting a deduction only to the extent that interest expense exceeded interest from tax-exempt obligations. H.R. Rep. 350, 67th Cong., 1st Sess. 16 (1921). The Senate deleted the proposed amendment so that no interest on indebtedness incurred to purchase tax-exempt securities was deductible, and the Conference Committee agreed. S. Rep. No. 275, 67th Cong. 1st Sess. 14 (1921); H.R. Rep. No. 486, 67th Cong., 1st Sess. 23 (1921).

During the 1921 Senate debate on the House proposal, it was stated that under the existing provision "a bank . . . owning a million dollars worth of 3½ percent bonds which are exempt can borrow the money of the Federal Reserve Bank up to a million dollars and be entirely exempt from taxation on the income from that money." 61 Cong. Rec. 6716 (1921). Thus, as early as 1921 it was clearly stated that the interest deduction prohibition did not apply to banks.

The House made a similar attempt in 1924 to amend Sections 214(a)(2) and 234(a)(2) to allow the deduction of interest paid on indebtedness (other than interest paid or incurred in carrying on of a trade or business) only to the extent that such interest exceeded the taxpayer's income from tax exempt securities. H.R. Rep. No. 398, 68th Cong., 1st Sess. 241 (1924); H.R. Rep. No. 844, 68th Cong., 1st Sess. 19 (1924).

In successfully opposing another attempt by the House to add such a provision to the Revenue Act of 1926, the Senate looked to the reduction in surtax rates to discourage the investment in the exempt securities and counteract the avoidance of taxes which would otherwise result. The Senate was apparently concerned that the indirect effect of the House amendment was to impose a tax upon interest which otherwise would be tax-exempt. H.R. Rep. No. 1, 69th Cong., 1st Sess. 7 (1926); S. Rep. No. 52, 69th Cong., 1st Sess. 21 (1926); H.R. Rep. No. 356, 69th Cong., 1st Sess. 34 (1926).

Section 214(a)(2) and Section 234(a)(2) were consolidated in 1928 as Section 23(b) of the Revenue Act of 1928. Section 23(b) was amended by the Revenue Act of 1932 to include interest on indebtedness incurred or continued in connection with the purchasing or carrying of an annuity. The language of the prior provisions was continued in Section 23(b) allowing a deduction for "all interest paid or accrued within the taxable year on indebtedness except . . . on indebtedness incurred or continued to purchase or carry obligations or securities . . . the interest upon which is wholly exempt from the taxes imposed by this title."

The legislative history of the Revenue Act of 1934 contains the most extensive discussion of the applicability of the limitation of the interest deduction to commercial banks. An amendment was proposed in the House to preclude a deduction for interest on indebtedness incurred or continued to purchase or carry, "or the proceeds of which were used to purchase or carry", wholly tax-exempt obligations. *The House Ways and Means Committee, in reviewing Section 23(b), concluded that under existing law banks were allowed to deduct interest on deposits even though the deposits were invested in tax-exempt obligations.* H.R. Rep. No. 704, 73d Cong., 2d Sess. 21-22 (1934).

The House Ways and Means Committee Report states: "Section 23(b) of existing law prohibits the deduction of interest on indebtedness incurred or continued to

purchase or carry tax-exempt securities. Thus, indebtedness incurred by a bank on its deposits is not treated under existing law as indebtedness incurred or continued to purchase or carry tax-exempt securities. Therefore, a taxpayer carrying on the banking business may deduct all the interest paid on deposits even though such deposits are invested in tax-exempt securities. For instance, suppose a bank pays interest of $16,000,000 in deposits. It receives from investing these deposits $20,000,000 of which $8,000,000 represents tax-exempt interest and $12,000,000 taxable interest. Since it is allowed to deduct the entire interest paid, namely, $16,000,000 it escapes tax entirely on the taxable interest of $12,000,000. This section of the bill provides that if the proceeds of indebtedness, such as bank deposits, are actually used to purchase or carry tax-exempt securities, no deduction shall be allowed for the interest incurred on such indebtedness. This will force the taxpayer in the example given to pay a tax on $4,000,000, instead of escaping tax entirely." Id.

The Senate Finance Committee strongly opposed the House bill, and rejected it primarily because of the Senate Committee's concern with the effect it would have on the marketing of tax-exempt securities. S. Rep. No. 558, 73d Cong., 2d Sess. 24 (1934). The Senate Finance Committee Report states: "Section 23(b) of existing law prohibits the deduction of interest paid or accrued on indebtedness incurred or continued to purchase or carry tax-exempt securities. The indebtedness incurred by a bank to its depositors is not treated under existing law as indebtedness incurred or continued to purchase or carry tax-exempt securities. This section of the House bill provides that if the proceeds of indebtedness, such as bank deposits, are actually used to purchase or carry tax-exempt securities, no deduction shall be allowed for the interest incurred on such indebtedness. *Your committee is of the opinion that the change made by the House bill will seriously interfere with the marketing of government securities, which are bought for the most part by banks and financial institutions, and also presents grave administrative difficulties. Your committee, therefore, disagrees with the change made in this section by the House bill and recommends that the provisions of existing law be continued.*" Id. (Emphasis supplied)

The Conference Committee, is rejecting the House proposals, reiterated the Senate Finance Committee's conclusions. H.R. Rep. No. 1385, 73d Cong., 2d Sess. 17 (1934). "Under existing law interest paid on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) is not allowed as a deduction if the interest received on such obligations is wholly exempt from income taxes. The House bill also denies the deduction if the proceeds of such indebtedness were used to purchase or carry such obligations, regardless of the purpose of the taxpayer in incurring such indebtedness. The Senate amendment restores the provisions of existing law; and the House recedes." Id.

During the House debate on the Conference Committee Report, Rep. Samuel Hill made the following comments: "*The amendments restore existing law, which permits banks to deduct from their gross income interest paid on deposits invested in tax-exempt securities. Your conferees came to the conclusion that the House provision, which denied a deduction in such cases, might seriously hamper the marketing of Government securities and be exceedingly difficult to administer.*" (Emphasis supplied.) 78 Cong. Rec. 7831 (1934) (remarks of Rep. Hill).

In 1935, Rep. McFarlane discussed the effect of the House provision as follows: "Section 23(b) of the present law provides for a deduction on account of interest paid or accrued within the taxable year, except on indebtedness incurred or continued to purchase or carry obligations the interest upon which is wholly exempt from tax.

The indebtedness incurred by banks in paying deposits is not treated as interest on money used to purchase exempt securities, even though these very deposits may be all invested in exempt securities. The effect of this construction is to make most of the larger banks exempt or practically exempt for income tax." 79 Cong. Rec. 14642 (1935) (remarks of Rep. McFarlane).

During hearings before the Senate Finance Committee on this issue, Mr. Charles P. Blinn, Jr., representing the American Bankers Association, raised objections to the proposed restriction on the deductibility of interest paid on deposits by banks. Hearings on the Revenue Act of 1934 Before the Senate Finance Committee, 73d Cong., 2d Sess. 206–207 (1934) (Statement of Charles P. Blinn, Jr.). "The effect of the amendment of Section 23(b) is to include as a tax paid, to carry United States securities interest which is paid on deposits. The effect of that is to reduce the income on Government securities now held by banks and to impair the tax-free covenants written into those securities. That should not be. The tax-free covenants in the securities should not be violated and the interest paid on deposits should continue to be a deduction as it is in the 1932 law. . . . Those bonds have been bought on this low basis because of the tax-free covenants . . . and the obligor gets the benefit of that rate on these securities." Id.

Section 23(b) was incorporated into the Internal Revenue Code of 1934, without change and became Section 265(2) of the Internal Revenue Code of 1954 again without substantive changes.

The Revenue Act of 1964 amended Section 265(2) by adding a provision regarding interest on face amount certificates issued by certain financial institutions registered under the Investment Company Act of 1940. The amendment did not apply to commercial banks by its express terms. The Senate Finance Committee Report stated that "the amendment does not affect the application of Section 265(2) in the case of banks." S. Rep. No. 830, Part 2, 88th Cong., 2d Sess. 226 (1964). The Committee's understanding of existing law as it related to banks was explained as follows: *"It has been held that interest paid on indebtedness represented by deposits in banks engaged in the general banking business is not subject to this provision since this indebtedness is not considered to be incurred or continued to purchase or carry tax-exempt obligations.* This position which has been a long-standing administrative practice was specified by Ruling in 1961" (Rev. Rul. 61-222, 1961-2 C.B. 58). (Emphasis supplied.) S. Rep. No. 830, 88th Cong., 2d Sess. 80 (1964).

During hearings before the House Committee on Banking and Currency regarding competition for savings and time deposits in 1966, the Treasury Department submitted the following statement, recognizing that Section 265(2) does not apply to savings and time deposits of commercial banks:

"A question has been raised as to whether commercial banks may use the proceeds of certificates of deposit to invest in municipal bonds, the interest on which is exempt from Federal income taxation, and deduct the interest paid on such certificates of deposit.

"The Internal Revenue Code provides in Section 265(2) that on indebtedness incurred or continued to purchase or carry obligations, the interest on which is exempt from tax, is not deductible. This provision was enacted to prevent the double benefit that would otherwise ensue from such borrowing and investment in municipal bonds. Were Section 265 not the law, the exempt income would not be taxable, and in addition, the interest on obligations incurred or continued to receive tax-exempt interest would be deductible.

"In the light of its legislative history, the provision has been interpreted to permit commercial banks to deduct the interest on time deposits. Certificates of deposit of commercial banks, because of their similarity to time deposits, have been treated in the same manner. Of course, interest on nondeposit obligations of banks, such as notes and debentures, incurred or continued to carry or purchase tax-exempt obligations is not treated in the same manner as interest on deposits." (Emphasis supplied.)

Hearing Before the House Committee on Banking and Currency on H.R. 14026, 89th Cong., 1st Sess., 152–153 (May 19, 1966).

These Committee Reports and floor debates demonstrate a clear Congressional intent that the interest deduction prohibition under Section 265(2) does not apply to commercial banks.

ADMINISTRATIVE HISTORY OF SECTION 265(2)—IRS AND TREASURY DEPARTMENT INTERPRETATIONS

Throughout the lengthy administrative history of Section 265(2), it has been recognized, almost without exception, that the Section 265(2) limitation on the deduction

for interest on indebtedness incurred or continued to purchase or carry tax-exempt securities does not apply to commercial banks. Commercial banks have, therefore, been allowed to deduct interest paid on deposits and other borrowings even though such borrowings may be invested to some extent in tax-exempt securities.

The present position taken by Treasury under the alternative minimum tax proposal is a total departure from the long-standing policy providing a special exemption from the Section 265(2) disallowance provisions for interest paid on bank deposits.

The IRS published its first opinion dealing with the application of Section 265(2) to commercial banks in 1924. It clearly recognized that bank indebtedness incurred by reason of accepting interest bearing deposits is not incurred to purchase or carry tax-exempt securities. I.T. 2028, III-2 C.B. 296 (1924). The amount of interest paid on deposits was, therefore, fully deductible as interest paid on indebtedness.

In S.R. 5128, IV-1 C.B. 156 (1925), the IRS allowed a taxpayer an interest deduction where the taxpayer, engaged in the shipping business, sold farm products on consignment, keeping the sale proceeds on deposit at 3 percent interest until needed by the consignor. The taxpayer invested the funds left on deposit with other funds of the taxpayer in various securities, including tax-exempt obligations. The IRS held that: "It cannot be said that indebtedness incurred by reason of such credits is incurred to purchase or carry tax-exempt securities. In this respect the taxpayer's business is in the nature of banking, *and in the case of a bank indebtedness incurred by reason of deposits which are invested in tax-exempt securities is not incurred to purchase or carry such securities.*" Id. (Emphasis supplied.)

Section 214(a) and Section 234(a)(2) of the Revenue Act of 1924 (the predecessors of Section 265(2) were applied by the IRS to dealers in investment securities, I.T. 1987, III-1 C.B. 142 (1924), and to joint stock land bank, G.C.M. 2000, VI-2 C.B. 248 (1927); however, the latter opinion did not involve indebtedness incurred in the ordinary course of a commercial banking business. See, *The First National Bank of Chicago*, 283 U.S. 142 (1931) (dealing with the deduction of interest expense attributable to a joint stock land bank in the consolidated return of an affiliated group.)

The IRS continued over the years to follow the policy of not applying the interest deduction prohibition under Section 265(2) to banks. Consistent with this policy, in 1961 it announced that the provisions of Section 265(2) have no application to interest paid on indebtedness represented by deposits in banks engaged in the general banking business since such indebtedness is not considered to be "indebtedness incurred or continued to purchase or carry" tax-exempt obligations. T.I.R. No. 348, December 1, 1961. This position was also published as Rev. Rul. 61-222, 1961-2 C.B. 58.

Section 265(2) was first applied to a commercial bank in Rev. Rul. 67-260, 1967-2 C.B. 132, in which the IRS denied a deduction for interest on indebtedness incurred by the bank on the issuance of certificates of deposit to a state in exchange for tax-exempt securities. Distinguishing Rev. Rul. 61-222, supra, the Service found that the certificates of deposit were issued by the bank for the specific purpose of acquiring tax-exempt obligations, the issuance of the certificates of deposit being the consideration for the acquisition of tax-exempt obligations, rather than being issued in the general course of the banking business of a commercial bank. The face amount of the certificates of deposit approximated the maturity values of the tax-exempt obligations. The maturity dates of the certificates of deposit approximately corresponded with the maturity dates of the tax-exempt obligations. In Rev. Rul. 71-163, 1971-1 C.B. 106, the Service reconsidered the retroactive application of Rev. Rul. 67-260 and determined that it should be prospectively applied to transactions entered into after August 21, 1967, the date of publication of Rev. Rul. 67-260 in the Internal Revenue Bulletin.

Except for the "back-to-back" transaction involved in Rev. Rul. 67-260, the IRS continued to exempt banks from the application of Section 265(2). Rev. Rul. 67-287, 1967-2 C.B. 133, provides that Section 265(2) will not apply to a bank that incurs interest expense as a result of short-term loans from a Federal funds from other banks or as a result of short-term loans from a Federal Reserve Bank, if such loans were obtained solely for the purpose of meeting the Federal Reserve System requirements for reserves against deposits.

In Rev. Proc. 70-20, 1970-2 C.B. 499, in a major policy statement, the Treasury Department set forth guidelines regarding the application of Section 265(2) to banks holding tax-exempt obligations. Rev. Proc. 70-20 generally provides that interest paid or accrued by banks on indebtedness which they incur in the ordinary course of their day-to-day business will not be disallowed under Section 265(2) unless there are circumstances demonstrating a direct connection between the borrowing and the tax-exempt investment. The Treasury indicated that ordinarily (barring unusual facts and circumstances such as in Rev. Rul. 67-260, supra) such a direct connection would not exist in the following classes of short-term bank indebtedness: bank de-

posits (including interbank deposits and borrowings); Federal funds transactions (and similar interbank borrowing); repurchase agreements (not involving tax-exempt securities); and borrowings directly from the Federal Reserve to meet reserve requirements. Interest on certain capital notes may also not fall within the Section 265(2) disallowance. Short-term indebtedness is defined as indebtedness for a term not to exceed three years.

In Rev. Proc. 70-20, the Treasury took particular note of the legislative history of Section 265(2) (and the unsuccessful attempts to amend its predecessors) finding that Congress clearly intended to disallow the interest deduction only upon a showing of a purpose by the taxpayer to use borrowed funds to purchase or carry tax-exempt securities. Following express reference to its original position regarding the inapplicability of Section 265(2) to banks in I.T. 2028 and Rev. Rul. 61-222, the Treasury noted that: "The Congress has repeatedly recognized that indebtedness incurred by a bank to its depositors is not to be treated as indebtedness incurred or continued to purchase or carry tax-exempt securities within the meaning of Section 265(2). *To do so would "seriously interfere with the marketing of government securities, which are bought for the most part by banks."* Rev. Proc. 70-20, 1970-2 C.B. 499. (Emphasis supplied.)

Rev. Proc. 72-18, 1972-1 C.B. 740, provides guidelines for the application of Section 265(2) to taxpayers other than banks, and to banks in unspecifed situations not dealt with in Rev. Proc. 70-20. Direct evidence of a purpose to purchase tax-exempt obligations exists where the proceeds of indebtedness are used for, and are directly traceable, the purchase of tax-exempt obligations.

In Rev. Proc. 78-34, 1978-2 C.B. 535, the Treasury applied Rev. Proc. 70-20 in ruling that Section 265(2) would not operate to disallow interest deductions on borrowings represented by U.S. Treasury tax and loan funds when such Treasury deposits are secured by pledges of tax-exempt obligations as collateral. Borrowing by depository banks of Treasury tax and loan funds, not withstanding the requirement to pledge tax-exempt obligations as collateral for these deposits, was held to be in the nature of a "demand" deposit given that Treasury has exclusive discretion over the availability of these funds and that they are not subject to negotiated rates or other market factors. (This rationale was considered somewhat faulty, in view of the fact that interest was paid on these deposits.)

In Rev. Proc. 80-55, 1980-2 C.B. 849, the Treasury asserted that Section 265(2) would be applied to disallow deductions for interest paid by commercial banks on time deposits of state funds collateralized with tax-exempt obligations. The Treasury distinguished time deposits from demand deposits, finding that the pledge of tax-exempt securities was direct evidence of a purpose to carry tax-exempt securities. It attempted to reconcile Rev. Proc. 78-34 and Rev. Proc. 80-55 on the basis that time deposits, unlike demand deposits, provide an unrestricted right to use the deposit funds for a stated period of time. Therefore, a bank holding state funds as time deposits collateralized with tax-exempt obligations was considered by the Treasury as being in virtually the same economic position as one who has borrowed to buy tax-exempt obligations.

Rev. Proc. 80-55 met with strong opposition in view of the long-standing exemption from Section 265(2) for banks evidenced by both the legislative history and legal precedents. The collateralization of time deposits by tax-exempt securities was a common, and widely understood transaction. In more than 30 states, State or local law *required* that deposits of State funds be collateralized with tax-exempt securities. Moreover, there was no statutory basis for distinguishing between demand and time deposits. As a result, in Rev. Proc. 81-16, 1981-1 C.B. 688, the Treasury revoked Rev. Proc. 80-55, noting that "it remains the position of the Internal Revenue Service that Section 265(2) will continue to apply to interest paid on deposits that are incurred outside of the banking business, or in circumstances demonstrating a direct connection between the borrowing and the tax-exempt obligations." Thus, Rev. Proc. 70-20 contines to reflect the operative rules for commerical banks under Section 265(2), as those rules have been interpreted by Congress since 1921.

Several private letter rulings have dealt with the application of Section 265(2) to commercial banks. In Letter Ruling 7908011 (November 3, 1978), an interest deduction was allowed with respect to interest on State time deposits collateralized by tax-exempt securities where, unlike the situation in Rev. Rul. 67-260, supra, the tax-exempt obligations were previously owned by the bank, were not received from the borrower, there was no correlation between maturity dates and no increase in the bank's tax-exempt holdings. The IRS noted that Section 265(2) makes a substantial distinction between banks and all other borrowers and that Congress has repeatedly recognized that indebtedness incurred by a bank to its depositors is not to be treated as indebtedness incurred or continued to purchase or carry tax-exempt securities

within the meaning of Section 265(2). Since the time deposits were made in the ordinary course of the bank's business and there were no circumstances demonstrating a direct connection between the borrowing and investment in tax-exempt securities, the interest on the deposits was not disallowed. Letter Ruling 7910007 (November 22, 1978) was substantially similar in both factual situation and result.

Historically, the Treasury's general acceptance of the legislative policy of Section 265(2) excepting banks from its application has resulted in very few cases being litigated dealing with the application of Section 265(2) to banks. Nevertheless, those courts faced with the issue have fully accepted the legislative history as further explanation of the statutory provision. In *Investors Diversified Services, Inc.* v. *United States,* 575 F. 2d 843 (Ct. Cl. 1978) (permitting a face amount certificate company an interest deduction for that portion of its portfolio excluding the statutory 15 percent safe harbor) the court noted that the bank exception under Section 265(2) is a "venerable administrative interpretation".

The Tax Court decision in *New Mexico Bancorporation* v. *Commissioner,* 74 T.C. 1342 (1980), considered the question of the application of Section 265(2) to a commercial bank. The bank owned various tax-exempt securities in order to meet federal liquidity requirements and to meet State pledging requirements for the acceptance of State deposits. The issue was whether Section 265(2) applied to disallow interest paid on certain repurchase agreements which were treated by the parties as deposits collateralized by tax-exempt securities. Upon characterization of the repurchase agreements as ordinary and customary depository transactions, the court held that it was clear that Section 265(2) did not apply to the bank.

CONCLUSION

Over a period of more than 60 years, the legislative history of Section 265(2) makes it abundantly clear that Congress has consistently interpreted Section 265(2) not to apply to interest expense incurred on bank deposits and other indebtedness acquired by a bank in the normal course of its banking business. The historical basis for this Congressional policy, which has been repeatedly stated, is that the application of Section 265(2) to commercial bank indebtedness would seriously interfere with the marketing of State and local government securities, and thus would negatively impact the ability of State and local governments to borrow funds to finance public projects.

Similarly, the Internal Revenue Service and the Treasury Department have recognized the clear intent of Congress with respect to this issue. Section 265(2) has not been applied to basnk indebtedness except in two instances. One situation involved a direct exchange between a bank and a State government of certificates of deposit and State obligations of like amounts and maturities. However, the disallowance of interest deductions in this situation was applied prospectively. The second involved Rev. Proc. 80-55, which would have disallowed interest expense deductions on State and local deposits collateralized by pledged tax-exempt securities. Rev. Proc. 80-55 was withdrawn by the Treasury in response to strong protests from Members of Congress that this position voilated Congressional intent.

Thus, the Administration's proposal under the proposed alternative minimum tax to disallow interest expense deductions on bank indebtedness through an allocation formula would be in direct conflict with Congressional policy and would reverse the policies of prior Administrations which have been enunciated since 1921. The negiative impact of the Administration's proposal would fall on State and local governments by significantly increasing their borrowing costs to fund public projects.

JOHN F. ROLPH III,
Vice President-Tax Legislation.

STATEMENT OF FLETCHER L. BYROM, CHAIRMAN, COMMITTEE FOR ECONOMIC DEVELOPMENT, AND CHAIRMAN, KOPPERS, CO., INC.

My name is Fletcher L. Byrom. I am Chairman of the Koppers Company and also of the Committee for Economic Development, an organization which is composed of 200 leading business executives and educators. I appreciate the opportunity to appear before you to discuss key economic policy issues that confront our nation today.

CED was founded just forty years ago, at a time when there were widespread fears that the end of World War II would bring a major economic downturn. The founders of CED were convinced that there was nothing inevitable about this. They believed—correctly—that with proper economic policies, both the U.S. and the world

economy could experience steady economic growth and high employment, based fundamentally on the productive strengths of the private enterprise system. To achieve this result, however, they argued it was essential that short-run fiscal, monetary and other economic policies be systematically and steadily geared to the nation's broad long-range economic goals. This emphasis has been a central feature of CED's thinking ever since.

There are some definite parallels to that earlier situation today, though I would certainly not want to drive the analogy too far. Our economy currently has an exceptional opportunity to embark on a sustained period of economic growth, based primarily on increased private capital investment and restoration of the U.S. competitive position. In the last several years, a growing national consensus has finally emerged that inflation must be brought under firm control; that the progressive liquidation of the capital base of our nation's economic system had to be halted; and that greater reliance needs to be placed on competitive market forces. Yet progress in these directions is now being seriously impeded by the high level of interest rates that is significantly related to the enormous prospective budget deficits and by the continuation of economic slack in this high-interest rate environment. These conditions are swamping the potential favorable effects on investment of recent policy changes, including particularly the major improvements in capital recovery allowances instituted last year.

There is now growing appreciation that without major further action, the budget deficit will not rise well above the hundred billion dollar mark in 1983 but will show successive yearly increases thereafter. This must simply not be allowed to happen—and both the markets and the public need to receive clear indications soon that it will not happen. It is imperative that early and convincing action be taken to reduce the magnitude and change the direction of these deficits to levels that are consistent with lower interest rates and sound economic recovery. A downward trend in these deficits must be clearly demonstrated and confidence built that such a trend will be sustained.

What I particularly want to stress here, however, is the importance of approaching the task of reducing the deficit in a way that is consistent with key long-term goals for the economy. Let me comment briefly on four of these goals that we regard as centrally important.

First, there is need for a progressive, year-by-year reduction in the inflation rate until essential price stability is achieved. The recent sharp deceleration in the rise of the Consumer Price Index is of course very gratifying. It would be a mistake, however, if we were to declare victory over inflation prematurely. As the chart attached to my testimony shows, the overall inflation rate has dropped significantly in all recent recessions, only to show a more pronounced rise in each recovery phase. There are strong reasons for believing that we are now witnessing more permanent progress toward bringing down the underlying inflation rate. The trend in various recent labor agreements toward more emphasis on labor-management cooperation to achieve greater productivity is particularly encouraging in that connection. But adequate progress toward the goal of reducing inflation cannot be taken for granted and fiscal and monetary policies, in particular, must be conducted on the assumption that inflationary risks remain great.

A second central policy aim is the achievement of healthy economic growth and high employment. Given the continuing inflationary threat, some modernization in the rate of long-term economic growth from what otherwise might have been desirable is probably necessary. But demand restraint must not become so severe that it blocks out necessary incentives for capital formation and productivity growth.[1]

Third, public policies need to be redirected so that a significantly greater share of the growing real Gross National Product will be devoted to investment and saving. We need more investment not only in new plant and equipment but also in more rapid technological progress and innovation, in domestic energy production and conservation, in improved skill training and education, and in public infrastructure.

Fourth, for reasons of both equity and humanity, national policy can and should give adequate weight to the concerns of those disadvantaged members of our society who have the greatest need.

Let me now outline the kind of approach toward reducing the deficit that, I believe, would adequately balance the various goals I have cited. While the specifics of this approach are my own, they are largely in line with postitions that CED has supported in the past. On that basis of an informal check with other CED trustees, I also believe that they would have wide support within our organization.

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[1] See CED's 1980 policy statement, "Fighting Inflation and Rebuilding a Sound Economy," p. 11.

1. The total reduction in the projected deficit must be adequate to make a major dent in existing inflationary expectations and reduce pressures on interest rates and financial markets sufficiently to allow for a major revival of capital investment.

2. Given the magnitude of the required cuts, no major segment of the budget should be excluded from consideration. Defense spending should be subjected to the same intensive scrutiny that has been applied to non-defense programs. This should permit significant savings from projected increases, at least by fiscal years 1984 and 1985, without any weakening in our basic defense posture. Better-honed strategies, plus improved procurement and pre-purchase planning ought to enable us to get more for our money. Such careful scrutiny of defense spending can strengthen our defense posture, because a strong economy is in itself a key ingredient of U.S. overall national security.

3. In the non-defense area, an important part of budgetary savings should come from slowdowns in the indexed growth of entitlement programs, including Social Security, which have been adjusted annually on the basis of the Consumer Price Index or some roughly equivalent index to take account of inflation. It would be neither realistic nor equitable to concentrate the principal burden of budget cuts on a narrower range of social programs, particularly those that were already subjected to heavy cuts last year. Indexed entitlement programs now constitute more than one-third of the total federal budget and an even larger portion of the non-defense budget. Adjustments to take account of inflation for these programs, have considerably exceeded the increase in average wages in the past few years.

On grounds of equity, therefore, there is a strong case for linking future increases in Social Security and other entitlement benefits to average wage increases rather than the rise in consumer prices whenever average wage increases are less than the consumer price rise. CED's Research and Policy Committee specifically endorsed such an approach with respect to Social Security in its statement on retirement policy.[2] However, while this rule would have produced important budgetary savings in the past few years, it cannot be counted on to produce savings in the next few years. Most current forecasts suggest that the rise in average wages will exceed increases in the Consumer Price Index, in line with more normal past patterns.

Hence, a number of other possibilities should be considered if budgetary savings are to be achieved through a slowdown in the indexed growth of entitlement programs. As we indicated in our statement on retirement policy last year, indexing of Social Security benefits at less than 100 percent for a period of several years would be equitable simply to correct in part for past increeases in Social Security benefits in excess of average increases in wage rates.

One way to accomplish this purpose would be a one-year or fifteen month moratorium on cost-of-living adjustments for all entitlement programs, starting this July and extending until either July 1983 or the end of the fiscal year in September 1983. According to the Congressional Budget Office, this would yield annual budget savings of $18 billion by fiscal year 1983 and $22 billion by fiscal year 1985. About three-quarters of these savings would come from Social Security. Another option would be to combine such a one-year or fifteen-month moratorium for all entitlement programs with allowing cost-of-living adjustments in subsequent years only for CPI increases in excess of 3 percent. By 1985, this combination (assuming a one-year moratorium) would produce an annual saving of $38 billion. A third option might be to start this July with the practice of basing cost-of-living adjustments on the rise in the CPI less three percentage points, yielding estimated savings of about $7 billion in fiscal year 1983 and $24 billion in fiscal year 1985.[3] In connection with all of these options, some exceptions to the rule for less-than-full indexing may be desirable to aid persons in the lowest income categories.

4. Budgetary savings in other programs are undoubtedly possible, in part through greater management efficiency. Care must be taken, however that essential social safety nets are in fact preserved. Moreover, in various programs such as those concerned with longer-term investment in productive plant and equipment and also in human resources, some budgetary cutbacks would actually be counterproductive in terms of the longer-range objectives I have outlined. I consider it particularly important, for example, that adequate funds be allocated for training the hard-to-employ, provided these programs are properly designed. Similarly, while I see a need for tightening up on student loan programs at both the college and graduate levels, I believe that overly drastic cuts in this area would run counter to the national need

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[2] See CED policy statement, "Reforming Retirement Policies," September 1981, p. 9.

[3] Still another option: holding cost-of-living adjustments to 85 percent of the rise in the CPI. Estimated savings: about $3 billion a year in fiscal year 1983 and $9 billion in 1985.

for more adequate investment in the kind of education and training that our workforce will need to be able to meet the requirements of the coming decades.

5. Even with a generous estimate of the savings that can be achieved through the measures I have recommended on the expenditure side of the budget, it is clear that a substantial contribution will also have to come from the revenue side if the overall deficit is to be brought down to manageable proportions.

6. A number of reasonable increases on the revenue side of the budget should be possible that would not interfere with achieving the long-run goals I have cited. In general, tax increases that fall on consumption, whether it be personal or business, are to be preferred. Some of these increases can be brought about by greater reliance on user taxes, as proposed by the Administration. Also, serious consideration should be given to increasing various federal excise taxes on alcohol, cigarettes, gasoline, and some luxury items, starting in 1983. Nor do I think corporations should go untouched. Review of certain of the tax changes affecting corporations that were enacted last year may be appropriate, specifically including the so-called safe harbor leasing provisions and some of the tax allowances on hydrocarbon extraction. At the same time, it is vitally important that needed incentives for investment in new plant and equipment be preserved, including especially provisions for adequate capital recovery allowances. The patent inadequacy of these allowances prior to last year, coupled with inflation and excessive regulatory burdens, was a major factor in the effective decapitalization of a great deal of our capital-intensive industry, particularly steel, non-ferrous metals, railroads, the airlines, and utilities.

I am concerned about the potential adverse effects of the proposed minimum corporate tax on investment incentives. For example, according to a recent article by Emil Sunley, Director of Tax Analysis for Deloitte, Haskins and Sells, about half of the revenue gain through imposition of the minimum tax would derive from limitations on just one tax preference, namely the use of the investment tax credit.[4] As Sunley goes on to explain, "Any minimum tax blunts the incentive effects of tax preferences. Congress, by enacting a minimum tax, in effect is saying that if a business engages only a little in activities encouraged by tax subsidies, . . . no minimum tax is imposed. But if the business is good at these activities and specializes in them, it will have to pay the minimum tax, putting it at a competitive disadvantage."

7. Even if the probable yield that can be realized from the kind of revenue measures I have cited should prove to be substantial, I find it hard to envisage that it would, in conjunction with realistically achievable expenditure cuts, be substantial enough to produce the decisive reduction in the potential deficit that is needed. Hence, I believe that we must look for additional revenues through deferral of the provisions for indexing personal income taxes beginning in fiscal year 1985 and, possibly, elimination or postponement of at least part of the personal income tax cut now scheduled for 1983. The potential added revenues from either or both of these steps, or possible variants that have been proposed, could, of course, be very large.[5]

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[4] See Tax Notes, Feb. 15, 1982.

[5] Shown below are estimated revenue effects of various alternative possibilities for deferral of the indexation of personal income taxes and of the scheduled reductions in these taxes. (Sources: Congressional Budget Office, "Reducing the Federal Deficit: Strategies and Options" (February 1982) and, for Item (e), Office of Senator Dole.)

(a) Full deferral or elimination of the scheduled 10 percent personal income tax cut in 1983 and of the tax indexing now scheduled to start in 1985. According to the Congressional Budget Office, these two steps combined would, on an annual basis, cut the prospective deficit by $9 billion in 1983, $37 billion in 1984, $54 billion in 1985, and $76 billion in 1986. On a cumulative basis, the estimated revenue savings would come to $46 billion in 1984, $100 billion by 1985, and $176 billion by 1986.

(b) Deferring tax indexation but retaining the 1983 tax cut. This would yield estimated annual savings of $12 billion in 1985, $30 billion in 1986 and $51 billion in 1987.

(c) Eliminating or deferring the entire 1983 personal income tax cut but retaining tax indexing. Annual savings: $9 billion in 1983, $37 billion in 1984, $40 billion in 1985 and $44 billion in 1986. Cumulative savings by 1985: $86 billion.

(d) Reducing the 1983 tax cut to 5 percent. This would, by itself, produce annual budget savings of $4 billion in 1983, $18 billion in 1984, $20 billion in 1985 and $22 billion in 1986. Cumulative savings by 1985: $42 billion.

(e) "Stretching out" the scheduled 1983 tax cut, so that a 5 percent cut would be scheduled for July 1, 1983 and another 5 percent cut for July 1984. This would save $4 billion in 1983 and $14 billion in 1984, but only $1 billion a year in 1985–87. Cumulative savings by 1985: $19 billion.

(f) Eliminating the scheduled 1983 tax cut but starting tax indexation in that year instead, as proposed by Senator Dole. Assuming 7 percent inflation in 1983, this would by 1985 produce about three-fourths of the accumulated savings generated by reducing the 1983 tax cut to 5 percent.

(g) Making activation of tax indexation beginning in 1985 contingent on specified improvements in the budget situation.

I would consider postponement of tax indexing ahead of any decision to defer the 1983 personal tax reduction. To reach the overall goal for reducing the deficit, however, it may as a last resort also be necessary to defer or stretch out at least part of the scheduled 1983 tax cut.

CED strongly favors a longer-run objective of gradually reducing the total share of GNP taken by taxes, in balance with the phased reduction in government spending as a share of GNP. We have also taken the position, however, that the nation must be prepared to finance any necessary increases in defense spending on a noninflationary basis. In this sense, deferment or stretch out of all or part of the 1983 tax cut and of the subsequent income tax indexation ought to be seen as part of the price that has to be paid for the projected sharp step-up in national security outlays.

If agreement on any package of budgetary trimming is to have its desired effect on the financial markets, business and the public, several conditions must be met. The first of these, to be quite blunt, is that the proposed plan must be fully credible. On too many ocasions spanning several Administrations and Congresses, budget numbers promulgated by the Executive Branch as well as the Congress have failed to meet that condition. Yet given the amount of supplemental information now available and the number of analysts with sharp pencils in financial houses, business firms, universities and the press who follow these numnbers, it now usually takes only a relatively short time before any lack of credibility becomes apparent to everybody. I very much hope, therefore, that any agreed new program for deficit reduction will from the start be one that is generally accepted as "adding up."

There must also be convincing indications that the proposed reductions will, in fact, be carried out. Congress' recent failure to pass a meaningful budget resolution and current talk of a possible breakdown of the entire budget process are clearly very detrimental in this connection.

I am not one of those who put the blame for all this on the budget process as such. The present procedures repesent a major advance over the way things were done prior to the Budget Act of 1974. Without the tools provided by that Act, the various participants in the current budget debate would not be able to discuss detailed budget projections for three or more years ahead, argue about economic assumptions, or come up with prompt estimates of potential budget savings through alternative approaches. Cynics might say this may not be all bad. But the fact is that the new process has given Congress major new tools for making more rational budget decisions. The chief problem lies in facing up to the basic choices now that they are being presented with greater clarity.

I do not think that new legislation is required this year to improve the budget process. But if the business community is to have continuing confidence that agreement on a deficit-reducing package will actually be carried out, it will be highly important that the Congress passes the required legislation expeditiously and adheres to the basic requirements and timetable of the budget procedure. We believe that various other steps should also be taken to make that procedure more effective, such as given binding force to the first resolution, bringing credit activities under closer control, moving various activities now classified as "off-budget" back into the budget, and subjecting not only the spending side but also the revenue side of the budget to closer scrutiny, particularly where it involves tax provisions that have the same purpose as particular expenditure programs and should be examined jointly with such programs. The most important immediate need, however, is to reach an agreement on an adequate cutback in the budget deficit that will be widely regarded as realistic.

With a credible program for progressively lowering the deficit in coming years, there is a strong chance that interest rates will be significantly reduced. Such a fiscal policy would provide assurance that monetary policy could be directed at fostering rates of monetary and credit expansion adequate to support noninflationary real growth in the economy.

Cutting deficits and improving the fiscal-monetary mix of course constitutes only part of what is needed to restore healthy noninflationary growth and make our economy more productive as well as competitive. Another part of the answer lies in removing inappropriate disincentives to the effective working of the market mechanism and in positive measures to increase productivity. The sharp slowdown in U.S. productivity growth since 1973 has been profoundly disturbing, particularly when one considers that our rate of productivity growth has lagged significantly behind those recorded by many of our major competitors among the industrial countries. CED is currently working on an in-depth study of how productivity might be improved, as well as on a parallel study that examines a desirable industrial strategy to make this country more competitive and allow it to adapt effectively to the emerging needs of the 1980s.

At the same time, we believe there is need for greatly increased focus on the potentials for more extensive public-private cooperation in a variety of areas. Just a few weeks ago, CED issued a new policy statement on the opportunities which public-private partnership poses for urban communities.[6] That statement examines in detail what has made for successful public-private cooperation in seven major cities—Atlanta, Baltimore, Chicago, Dallas, Minneapolis-St. Paul, Pittsburgh, and Portland, Oregon—and points to the elements of these successes that may be transferable to other communities.

Our earlier 1978 statement "Jobs for the Hard-to-Employ: New Directions for a Public-Private Partnership" similarly pointed to successful instances of public-private cooperation in developing training and job programs for the disadvantaged. While that statement served as a catalyst for increased private sector involvement in these efforts, including the creation of Private Industry Councils, we are by no means satified that these efforts are as vigorous or effective as they could be. CED's Program Committee expects shortly to issue a statement which spells out the steps that we believe are needed to achieve more effective and sustained business involvement in this area. Steps to enable smaller businesses to participate effectively in these programs will be an important element of our recommendations since a high proportion of the new entry-level jobs for the disadvantaged opens up in smaller businesses.

I myself have taken a special interest in another area of needed public-private partnership: namely, ways in which businessmen can help to improve the caliber of our nation's high school graduates. The quality of workers entering the labor force in the next few years will be of major importance for the success of our efforts to revitalize the nation's economy. There is a great deal that business can do in cooperation with local educational institutions, to assist in developing high school graduates who are not only well-rounded academically but who also have the flexibility and capacity for leadership needed to cope with the challenges of the coming decades.

I want to make it very clear that in emphasizing the potentials for public-private partnership in a variety of fields, we are not suggesting that the private sector can or should be expected to assume full responsibility for meeting needs that will result from current cutbacks in federal domestic programs. What we are saying is that with time and proper preparation, public-private cooperation at the local level can accomplish a great deal more than is generally realized, This can, in time, also help lighten the burden on public sector budgets. We are also saying that success in these efforts does not depend on money alone but requires creative and energetic personal involvement by public and private local leaders to work out mutual programs in a constructive fashion. The President's new Task Force on Private Sector Initiatives which is headed by my good friend, Bill Verity, is working hard on plans for encouraging such involvement.

All of these efforts at public-private cooperation can contribute to a national economic environment that is conducive to steady, noninflationary growth. But early and convincing action to restore the more viable fiscal-monetary mix needed to achieve that goal should be everyone's first order of priority today.

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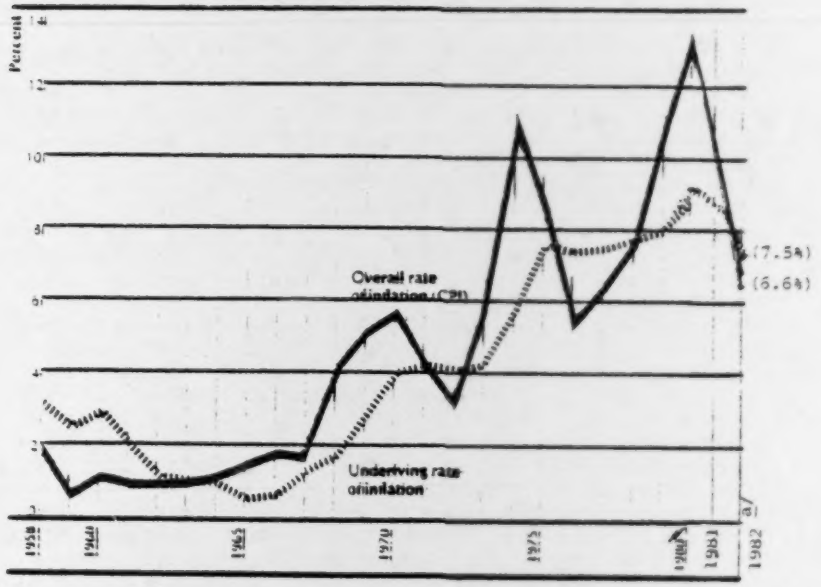
[6] See CED policy statement "Public-Private Partnerships: An Opportunity for Urban Communities," February 1982.

FIGURE 1

Overall and Underlying Rates of Inflation



Various alternative measures can be used to depict overall and underlying inflation. In this chart, the overall inflation rate is represented by the consumer price index (CPI). Underlying inflation is represented by the "core rate" concept developed by Data Resources, which measures the weighted average of the trend rates of growth in unit labor and capital costs (with weights equal to the estimated shares of these costs in total value added and with adjustments for productivity growth). For a detailed technical description, see Otto Eckstein and Robin Siegel, "More on Core Inflation," *Data Resources U.S. Review* (June 1979), pp.I.19–I.23.

a/ 1982 figures partly estimated by Data Resources.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics, and Data Resources, Inc.

COMMONWEALTH EDISON,
Chicago, Ill., April 7, 1982.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: I am Chairman of Commonwealth Edison Company, which supplies electricity to nearly three million customers in Chicago and the northern third of Illinois. I am also a member of the Board of the Edison Electric Institute (the "Institute"), an association of the nation's investor-owned utility companies, which provide electric service to more than 77 percent of the nation's electricity users.

On behalf of the Institute, I am enclosing a statement setting forth its positions with respect to the Administration's proposals on tax revisions and improved collection and enforcement measures and also on safe-harbor leasing. On behalf of Commonwealth Edison Company, I wish also to address in greater depth two subjects covered in the Institute's statement: the proposed minimum tax and safe-harbor leasing.

On behalf of both the Institute and Commonwealth Edison Company, I wish to commend your Committee, the Congress, and the Administration for the forward-looking approach which was taken in the Economic Recovery Tax Act of 1981 ("ERTA") to stimulate capital formation.

However, we are alarmed at the Administration's proposed alternative minimum tax and the proposals of others to repeal the leasing provision of ERTA. If enacted, the combined effect of these proposals would be to virtually wipe out the tax relief provided to utilities by ERTA and place Commonwealth Edison and many other electric utility companies in a worse financial position than existed before it was enacted.

As you know, the electric utility industry is the nation's most capital-intensive, spending approximately $30 billion a year on construction. The fact of the matter is that the electric utility industry is the largest single user of capital, except for the federal government. Indeed, electric utilities account for nearly half of all the common equity financing each year and almost one-fourth of all private-sector borrowing.

The problem is that the financial condition of the electric utility industry has deteriorated to the point that many companies are now barely able to finance their constructive programs. On one hand, their construction costs have risen much more rapidly than inflation generally. This is in large part because of changing governmental requirements related to environmental and safety concerns and construction delays stemming from the regulatory process. On the one hand, because electric rates are regulated, they have not been permitted to keep pace with the rapidly escalating costs of doing business. The net result is that our industry is experiencing increasing difficulty in financing its construction programs because of diminishing earnings and coverages. The seriousness of this problem is illustrated by a recent study by E. F. Hutton, which shows that the bond ratings of as many as 25 electric utility companies were lowered within the past year. The industry's weakened financial condition is also reflected in the industry's weakened financial condition is also reflected in the results of Salomon Brothers's recent study of strengths or weaknesses of the common stocks of 100 major electric utilities. The study found that the common stock of only six of these companies is selling at greater than book value and that the average market-to-book-price ratio of the 100 companies is only 18 percent. No one doubts that adequate supplies of electricity are vital to the nation's economic well being and that additional amounts of electric power will be required. If these financial problems are not corrected, they will eventually undermine the very integrity of the nation's electric power supply systems.

It is ironic that the industry with the greatest capital investment needs and the greatest difficulty in meeting them received, except for the tax-deferred dividend reinvestment provision which already has proved to be a valuable source of new funds, less than a full share of tax relief under ERTA. ERTA was intended to promote capital formation, primarily through ACRS depreciation. Under ACRS, the cost recovery period for most property of other businesses is five years while the vast majority of utility property has a cost recovery period of either ten or 15 years. In cases such as ours, the modest depreciation relief provided by ERTA for utilities will be offset during the next several years by the apparent elimination of the "repair allowance," a feature of the prior depreciation system.

The principal capital incentives which Congress has provided are the investment tax credit and accelerated depreciation. But because both of these benefits are distributed through the tax system, they are unavailable if there is insufficient taxable income to absorb them. Even if a company is financially healthy, the capital formation incentives will be unusable if the ratios of funds for construction to current earnings or of debt financing to equity financing are too high. It is the nature of the electric industry for both of these ratios to be on the high side, and the general unwillingness of regulatory commissions to allow adequate earnings has made them still higher. Even before ERTA, a number of utilities had resorted to traditional leasing arrangements in order to salvage a portion of these otherwise unusable tax benefits, even though a substantial fraction of these benefits was required to be left with the leasing companies under the then-prevailing Internal Revenue Service rules. The safe-harbor leasing rules of ERTA were designed by the Treasury to permit the efficient utilization of the incentives provided by the investment tax credit and accelerated depreciations. Without safe-harbor leasing, the depreciation relief provided by ERTA would have been largely meaningless to the utilities, at least for the foreseeable future.

Thus, for the reasons explained, the capital cost benefits provided by ERTA were modest for the industry, and the realization of the benefits which were provided in many instances, depend heavily upon the safe-harbor leasing provision. We are now faced with proposals—the Administration's minimum tax proposal and proposals to repeal leasing—which would largely undo the modest benefits. For the reasons explained below, the Administration's new minimum tax proposals would drastically curtail the ability of Commonwealth Edison Company and many other electric util-

ity companies to utilize accumulated investment tax credits which we have, unfortunately, been able to use in the past for the reasons described. Under the Administration's proposals, currently generated investment credits could continue to be utilized by safe-harbor leasing, albeit at the cost of losing perhaps 15 percent of the value of the incentives to lessors. But even this benefit would be lost if the Congress should adopt the proposals of some to repeal the safe-harbor leasing provision of ERTA.

Alternative corporate minimum tax

The Administration has proposed a greatly expanded minimum tax for corporations.

We urge that your Committee consider very carefully whether a minimum tax makes sense when applied to normal business operations.

When applied in the context of individual taxpayers subject to steeply graduated tax brackets, a minimum tax has been useful because it has restricted the degree to which taxpayers can "arbitrage" differences in their brackets and because it has lessened the spectacle of wealthy individuals eliminating all tax liability by dabbling in large tax shelters. It is important to remember, too, that a key preference in the case of the individual minimum tax is large "personal," (i.e., non-business) deductions.

In the case of an operating business, in contrast, none of the preferences proposed are "personal" items, and all are business incentive items. The economic effect of business incentives is to reduce the costs of particular business investments or activities. Business taxpayers subject to the minimum tax would accordingly have lesser cost reductions (because a part is taken away by the tax) than business taxpayers not subject to the tax. If one taxpayer's costs are reduced more than another's, the latter taxpayer becomes competitively disadvantaged. As the preference items proposed are by statute attached to certain kinds of business activity and, as "too many" preferences trigger the minimum tax, the spectre of the tax would tend to discourage businesses from doing "too much business" of a kind that has incentives attached. Your Committee must seriously ask itself whether it is desirable to impose a tax which defers operating businesses from doing "too much business" in today's depressed economy.

But whatever the merits of a minimum tax generally, the particular form of minimum tax proposed by the Adminstration would be devastating for capital-intensive companies, and extra devastating for capital-intensive companies, like utilities, struggling with financial difficulties. The devastation comes from the fact that the chief effect of the Administration's proposed tax would be to drastically curtail the investment credit for companies with large capital investment requirements. This effect is not immediately obvious because the investment tax credit is not formally listed as a preference item. However, under the proposal, companies would not be permitted to take the investment tax credit into account in computing their minimum tax and the real result of this limitation would be to reduce from 90 percent to 67.4 percent the amount by which the investment credit could be applied against a corporation's tax liability. The minimum tax attributable to this curtailing of the investment credit would be larger than the minimum tax attributable to any of the official preference items. We are advised that the Treasury estimates that about half of the total minimum tax revenues would come from the manner in which the minimum tax would curtail the utilization of investment tax credits. Thus, as presently proposed, the effect of the minimum tax would be geared more to the lessening of investment tax credit benefits than to the imposing of a tax on preference items.

Because of this investment tax credit effect, the proposed minimum tax would greatly compound the already critical difficulties of financially strapped utilities at this crucial time. Even though electric utility companies generally have negligible amounts of tax preference items, they would be subjected to large penalties in the form of the alternative minimum tax. In effect, the investment credit would be turned into a tax preference item instead of an incentive provision. Such a change would represent a direct reversal of the national policy that has been a basic part of the tax law since 1962.

Commonwealth Edison estimates that the proposed alternative minimum tax would increase the amount of federal income tax that we would have to pay for the period 1983 through 1986 by approximately $175 million—notwithstanding that we have virtually none of the preference items which are ostensibly the subject of the tax. This would mean that funds which otherwise would be devoted to the construction of new facilities would have to be used to pay federal income taxes As a result, we would undoubtedly be forced to issue additional shares of stock and increase our

debt to replace the funds required by the alternative minimum tax. This would come at a time when we and many other utilities are struggling to complete construction of new generating capacity started a decade or more ago. At a minimum, the cost of electricity to Commonwealth Edison's customers would have to be increased to reflect the cost of this additional financing. The impact could be more severe if this restricts our access to the financial markets.

Estimates of the combined effect of the proposed alternative minimum tax on the electric utility industry is even more dramatic. A recent survey of the Institute's member companies shows that the companies in our industry which would incur a liability for the alternative minimum tax would have to pay as much as $2 billion more in federal income taxes over the four-year period ending n 1986. The survey highlights the fact that the alternative minimum tax tends to penalize utilities which are struggling to complete construction programs at a time when they most need tax relief for the reason that companies which have completed their construction programs tend to be financially stronger and thus would incur little or no alternative minimum tax. In other words, a disproportionate part of the $2 billion would come from the financially weaker utilities. Surely this is an upsidedown result!

If there is to be a minimum tax, we believe that it should apply only to companies whose earnings are strong but which pay little or no tax because of the designated tax preference items. At a minimum, an alternative minimum tax should allow utilization of the investment credit, including carryovers, to offset 90 percent of any alternative minimum tax liability, except to the extent that the tax is attributable to the enumerated tax preference items.[1] As a practical matter, the impact of the alternative minimum tax on this basis would be to eliminate the bias against utilities with large construction programs.

Safe-harbor leasing

Commonwealth Edison has accumulated about $400 million of investment credits that it cannot immediately use, and construction expenditures to be made in 1982 will generate nearly $130 million of additional investment credits. Other electric utilities face similar situations.

Inability to use investment credits, or to use them on a timely basis, causes utilities to resort to raising capital in the marketplace even more frequently than they otherwise would. This, in turn, creates the need for higher electric rates than would otherwise be required. Forcing utility customers to pay relatively more for electricity than for other commodities, makes it even harder for utilities to obtain adequate and timely rate increases. This would put even more pressure on earnings and coverages and thus further exacerbate the industry's already difficult financing problems. In short, everybody is worse off.

The safe-harbor leasing rules were designed to prevent this from happening and to permit the companies to realize the unused incentives by selling them, in effect, to comanies that can use them. We understand that many electric utilities had been planning, and still wish, to enter into safe-harbor leases in order to utilize, at least on a more timely basis, some of their unutilized investment credits. In other words, safe-harbor leases are expected to provide a material portion of the capital that we need for construction. To repeal the safe-harbor provision would take away an important source of capital, resulting in additional, heavy financial burdens on many electric utilities. Repeal of the safe-harbor provision would thus be most damaging. On the other hand, amending the safe-harbor provision to limit the amount by which a lessor may offset its taxable income, by say 50 percent, would respond to adverse public perceptions and would seem to be appropriate if it does not unduly dry up the pool of potential lessors.

The institute's detailed discussion

I respectfully request that the enclosed detailed statement presenting the Institute's positions with respect to the Administration's proposals and with respect to safe-harbor leasing, and this letter, be made part of the record of the hearings of your Committee.

We appreciate the opportunity to present the positions of our industry and Commonwealth Edison Company on these very important matters.

Sincerely,

JAMES J. O'CONNOR,
Chairman and President.

Enclosure.

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[1] Of course, under extant law, 90 percent of the regular income tax may be offset by the investment credit, including carryovers.

Statement Submitted on Behalf of the Edison Electric Institute

Positions Regarding Certain Provisions of the Administration's Proposals for Tax Revisions and Improved Collection and Enforcement Measures and Safe-Harbor Leasing

This statement is presented on behalf of the Edison Electric Institute ("Institute") with respect to the proposals of the Administration for tax revisions and improved collection and enforcement measures and with respect to safe-harbor leasing. The Institute is the association of the nation's investor-owned electric utility companies, which provide electric service to more than 77 percent of the nation's electricity users.

The electric utility industry is the nation's most capital-intensive. It has a construction program approximating $30 billion annually, and despite the positive provisions of the Economic Recovery Tax Act of 1981 ("ERTA"), it is still experiencing major problems in financing its capital investments. The raising of such a significant amount of new capital is becoming increasingly difficult as is illustrated by a recent study made by E. F. Hutton, which indicates that as many as 25 electric utility companies have had their bond ratings lowered within the past year. The ailing financial health of the industry also is reflected in the results of a recent study made by Salomon Brothers of 100 electric utilities, which indicates that the common stock of only six of these companies is selling at greater than book value and that the average market-to-book-price ratio of the 100 companies is only 81 percent.

The Institute has studied the Administration's proposals for tax revisions and improved collection and enforcement measures, and while mindful of the magnitude of anticipated budget deficits and the need for increased revenues, must point out that many of the Administration's new tax proposals would directly counter existing capital incentive provisions in the Internal Revenue Code. In essence, some of the proposals would represent a new tax on jobs, investment, and economic growth.

Because of the industry's unrelenting need to raise tremendous amounts of capital, the Congress is urged not to make changes in the tax law that might further weaken the financial condition of electric utility companies and thereby impair their ability to maintain a system of electrical supply which will be essential to the economic well-being of the nation in the years ahead.

Alternative corporate minimum tax

Under extant law, corporations must pay a minimum tax, in addition to "regular" income tax, equal to 15 percent of certain designated tax preference items. The Administration proposes to repeal this add-on minimum tax effective January 1, 1983 and to replace it with an alternative minimum tax which would require corporations to pay the greater of their regular income tax or an alternative tax equal to 15 percent of their alternative tax base in excess of $50,000. This alternative tax base would consist of the total of regular taxable income and 14 designated tax preference items. Investment tax credits would not be allowed as offsets against the alternative minimum tax.

The proposed alternative minimum tax would compound the difficulties of the many already financially strapped utilities by imposing a penalty on them in the form of an additional tax liability even though they generally do not have a substantial amount of tax preference items. Even if a company would be able to carry over the amount of the alternative minimum tax paid to offset regular income tax in later years, the alternative minimum tax still would be a substantial burden to those electric utilities currently in more precarious financial positions.

The practical result of the alternative minimum tax would be to reduce from 90 percent to 67.4 percent the amount by which investment tax credits may be applied against a corporation's regular income tax liability. In effect, the investment tax credit would be turned into the fifteenth tax preference item, changing it from an incentive provision; such a change would reverse a national policy that has been a basic part of the tax law since 1962.

The Institute surveyed its member companies to determine the effect that the alternative minimum tax would have on the electric utility industry. The results confirm that the alternative minimum tax generally would act as a penalty on those companies that are in less healthy financial situations, while not affecting those companies that are in stronger financial positions. To impose an additional tax on companies that already are in financial difficulty seems unwarranted. If there is to be a minimum tax, it should apply only to companies that are economically healthy but pay little tax because of the 14 tax preference items.

The survey results revealed that, of the 50 companies that responded, at least 27, which produce about 40 percent of the sales of electricity by investor-owned electric

utility companies, would incur a liability for the proposed alternative minimum tax, as shown below:

ESTIMATED INCREASE IN TAX LIABILITIES

Year	Amount (millions)	Number of companies
1983	$307	27
1984	348	24
1985	356	23
1986	273	22
Total	1,284	

It can be reasonably assumed, based on the date as reported above, that the increase in tax liabilities for the period 1983 through 1986 would approach $2 billion if all of the Institute's member companies were taken into account.

Because the proposed alternative minimum tax would place greater financial burdens on companies that are already struggling to raise tremendous amounts of capital, it should not be enacted. However, if an alternative mimimum tax were enacted, it should be modified to allow utilization of the investment tax credit, including carryovers, to offset 90 percent of any alternative mimimum tax liability, except to the extent that the tax is attributable to the 14 tax preference items. The impact of the alternative mimimum tax would then apply only to corporations that claim substantial amounts of tax preferences.

Similarly, new net operating loss carryovers, to the extent not attributed to the utilization of the 14 tax preference items, should be allowed as a reduction of the alternative minimum tax base. Failure to allow this offset would inequitably penalize businesses that suffer short-term economic losses as well as new companies that are not immediately profitable.

The proposed alternative mimimum tax would: (i) substantially reduce the existing benefits of the investment tax credit; (ii) harm the financially weaker companies; (iii) negatively impact upon companies that do not have substantial amounts of tax preference items; (iv) serve as a disincentive to capital formation and economic growth. The proposal would not simply be a "loophole closer"; rather, it would directly impair existing tax incentives and would represent a new direction in tax policy which is counter to the aims of ERTA and other measures to aid capital formation.

Industrial development bonds

The Administration proposes new restrictions on the issuance of tax-exempt bonds for "private purposes." Of particular concern to our industry is the recommendation by the Administration for an election of either tax-exempt financing or the use of the new Accelerated Cost Recovery System ("ACRS"). Under the proposal, the costs of depreciable assets financed with industrial development bonds could be recovered only under the straight-line depreciation method over periods substantially longer than the ACRS classes.

The investor-owned utility industry generally uses industrial development bonds to finance pollution control facilities, sewage and solid waste disposal facilities, and facilities for the local furnishing of electric energy. The Institute urges that no changes be made that would limit the issuance of tax-exempt bonds to finance such facilities or to lessen the benefits of their use.

The Institute agrees with the Treasury Department that a valid distinction can be made between quasi-public and strictly private uses of facilities which are financed with industrial development bonds. Clearly, the types of facilities that the electric utility industry finances with tax-exempts serve quasi-public functions. Any legislation to limit industrial development bond financing or to lessen its benefits should apply only to issues that serve strictly private purposes.

Financing pollution control facilities and facilities for sewage and solid waste disposal with tax-exempts not only is essential but also is fully justified on grounds that do not apply to tax-exempt financing for most other purposes. First, the use of pollution control and similar facilities does not create a profit for any private party, whereas most other facilities financed with tax-exempts are used for the profit of private parties. Pollution control and related facilities benefit only the general public, and in an economic sense, they produce only the burden of increased costs of

doing business for the user of the facilities. Second, pollution control and related facilities usually are installed because the law so requires and that is not true of the typical facilities that are financed with tax-exempts. This has two corollaries: The availability of relatively low-cost, tax-exempt money does not cause a misdirection of investment; that is, investment in pollution control and related facilities is not used as a tax shelter. The other corollary is that a business which is required by government to make an investment has a better claim on help from the government than a business that makes a discretionary investment.

Similarly, the local furnishing of electric energy is a quasi-public function. The investor-owned electric utility industry is a regulated industry precisely because the furnishing of electric energy is perceived to serve a public purpose, on which the health and safety of the nation's populace depend. Utilities are required by law to provide adequate electric service, and the use of industrial development bonds for the local furnishing of electric energy is a vital component in the industry's ability to meet the legal requirement to provide adequate, reliable service to customers at reasonable cost.

Existing restrictions that apply to tax-exempt financing of pollution control and related facilities and facilities for the local furnishing of electricity already limit their use. "Local furnishing" is defined in the tax law as that which is limited to an area which includes not more than two counties or a city and one contiguous county. This means that very few facilities qualify. With respect to pollution control facilities, the Internal Revenue Service has applied a very restrictive definition; in fact, its definition has been unduly restrictive.

The Administration's proposal to allow an election of either tax-exempt financing or the use of ACRS, in reality, is no election at all. Under the proposal, a significant portion of the facilities which utilities might finance by means of industrial development bonds would have to be depreciated using the straight-line method and a life of 35 years. This would be particularly onerous and would effectively preclude most industrial development bond financings by utilities in the future because the benefits of such would be outweighed by the penalty of having to use straight-line depreciation and a life of 35 years.

Withholding on interest and dividends

Current law does not require withholding on the payment of interest and dividends except in the case of payments to certain foreign persons. The Administration proposes that withholding on dividend and interest payments be made at a flat five-percent rate, beginning January 1, 1983, but certain exceptions would be permitted.

The Institute opposes the withholding of tax on dividends and interest because it would accelerate the payment of tax by investors, thereby reducing their rate of return, with the virtually inevitable effect that their incentive to invest in the electric utility industry at a time when the industry sorely needs additional capital, would be reduced. Furthermore, it would be a complex and expensive system to administer, particularly with respect to the administration of exemptions. However, the Institute would support a measure calling for increased information reporting by payers of income.

Accelerated corporate income tax payments

The Administration proposes, for tax years after 1982, an acceleration of estimated tax payments so that 90 percent rather than 80 percent of a corporation's income tax liability would have to be paid in a current tax year. The remaining liability would have to be paid no later than the fifteenth day of the third month following the close of a taxable year, in lieu of the present system whereby a corporation may pay the remaining portion in two installments, on the fifteenth day of the third and sixth months after the close of a taxable year.

This would not increase the amount of tax paid but would, however, impose an increased capital requirement on corporations. The additional financing costs necessary to meet the accelerated payment deadlines would only add to the electric utility industry's financial burdens.

Business energy tax incentives

Current law provides for a number of nonrefundable energy tax credits for investments in certain business energy property. Among properties eligible for such credits are alternative energy property, congeneration equipment, recycling equipment, solar or wind energy property, ocean thermal equipment, geothermal equipment, and low-head hydroelectric property. Some of these credits are scheduled to expire on Deceamber 31, 1982, some on December 31, 1985. The Administration proposes the repeal of all of the business energy tax credits effective January 1, 1983.

Utility companies are generally prohibited from using energy tax credits. However, an electric utility company may enter into a joint venture in a non-utility operation and thus be eligible for the business energy credits. If energy credits were eliminated, such operations would become less economic. Further, existing energy tax credits are important incentives for conserving oil and gas and for producing alternative sources of energy. They should not be repealed.

Construction period interest and taxes

The Administration proposes to amend the Internal Revenue Code to require corporations generally to capitalize and amortize interest and taxes incurred in the construction of non-residential real property.

The proposal needs to be clarified, particularly with respect to the definition of "non-residential real property." If the proposal were adopted, the Institute urges that it apply only to buildings, as defined in Section 1250 of the Internal Revenue Code.

Safe-harbor leasing

The Institute is aware that the Administration has not proposed either to eliminate or substantially revise the safe-harbor leasing provision of ERTA. However, the Institute is also aware that a number of proposals have been introduced to eliminate or to revise substantially safe-harbor leasing and that, in any event, the safe-harbor leasing provision will come under serious Congressional scrutiny.

The investor-owned electric utility industry has made use of the safe-harbor leasing provision, both as lessors and lessees. In the absence of safe-harbor leasing, many companies would have accelerated depreciation deductions and/or investment tax credits that they could not fully use. Thus capital costs would, to that extent, be increased. Repeal or substantial modification of safe-harbor leasing would have a significant negative impact upon capital formation for the electric utility industry, a result again contrary to the intent of ERTA.

The Institute understands that the Congress may wish to review the safe-harbor leasing provision to correct possible abuses and ensure that no unintended benefits have arisen thereunder. It is submitted, therefore, that amending the provision to limit the amount by which a lessor may offset, say by 50 percent, of its taxable income would be more appropriate than repeal of the safe-harbor provision.

COMMONWEALTH ELECTRIC CO.,
Norwalk, Conn., March 9, 1982.

Re: Percentage of Completion Method of Accounting for Income Taxes.

HOUSE WAYS AND MEANS COMMITTEE,
U.S. House of Representatives,
Washington, D.C.

GENTLEMEN: I am writing on behalf of Commonwealth Electric Company to express our concern over proposed changes in the completed contract method of accounting tax purposes. It is our experience that the tax accounting rules applying to this method are a necessary response to the unique characteristics and vulnerabilities of the construction industry, and their modification or elimination would have an adverse impact on the industry specifically and the economy as a whole.

Unlike many other business sectors, the construction industry experiences financial and operating problems which substantially affect its ability to forecast profits prior to the completion of a contract. The absence of a controlled work environment, constant modifications of construction plans to meet changing technologies and customer specifications, and significant risk factors contribute to this fundamental uncertainty. As a result, company profits are difficult or even impossible to forecast prior to the completion of a project which may not even be finished during the same taxable year.

In addition, construction receipts routinely lag behind expenditures due to contract retainage provisions, a situation which aggravates cash flow problems and greatly increases the need for interim working capital. These and other special characteristics of contruction work were recognized by the federal tax system 1918 and affirmed in revenue rulings as recently as 1970 by permitting construction companies to report their income on a completed contract basis. Current economic conditions make the option of electing such accounting procedures even more critical.

It is our belief that elimination of the completed contract accounting method would increase the financing burden of the construction industry so severely that many firms would be forced out of business altogether. In addition, contract prices

themselves would escalate, contributing substantially to the rate of inflation in the entire U.S. economy.

We strongly endorse the review and recommendations presented by Arthur Andersen & Company in its October 16, 1981 memorandum on completed contract accounting. I am attaching a copy of that document, and strongly urge you to consider its analysis. We would, of course, be pleased to duscuss any of the issues it raises with you.

Sincerely yours,

PHILLIP C. SHEPPARD,
Executive Vice President.

Enclosure.

ARTHUR ANDERSEN & Co.,
Washington, D.C., October 19, 1981.

Hon. DONALD T. REGAN,
Secretary of the Treasury,
Washington, D.C.

DEAR MR. SECRETARY: Attached is a memorandum prepared by our Firm concerning the proposed elimination or significant modification of the completed contract method of accounting for tax purposes. Copies of the memorandum are also being sent directly to Under Secretary Norman Ture and Assistant Secretary John Chapoton.

Based on our experience in working with many taxpayers who have used the completed contract method for a great many years, we urge that Treasury not advocate the elimination or significant modification of this method. If there are significant areas of abuse in the application of the method, we believe the appropriate way to deal with them, once they have been identified, is to commence a dialogue among Treasury and IRS officials, representative groups of taxpayers who use this method, and professional tax practitioners who are involved in this area. We believe that existing tax regulations (Reg. Sec. 1.451-3) are adequate to deal with major abuses but, if minor modifications of the regulations are needed, the appropriate procedure is to make proposed changes and permit discussion and comments from interested parties.

As discussed in the memorandum, the financial and operating problems of taxpayers using the completed contract method are somewhat unique. Eliminating an accepted tax accounting procedure that has been recognized and unlisted for over sixty years will (1) adversely affect the financial stability of many companies presently using the method, (2) increase inflationary pressures on government and private contract work on long term projects because of the increased costs of performing those contracts, (3) possibly have an adverse impact on our ability to increase national defense efforts, and (4) reduce the level of competition in many sectors of industry by forcing small and medium size companies out of business. Accordingly, we urge that the Treasury Department not recommend the elimination or major modification of the completed contract tax regulations.

We appreciate the opportunity to present our views on this important tax policy issue, and would be pleased to discuss these matters in more detail with you or others in the Treasury Department.

Very truly yours,

WILLIAM C. PENICK.

Enclosure.

MEMORANDUM ON THE PROPOSED ELIMINATION OR SIGNIFICANT MODIFICATION OF THE COMPLETED CONTRACT METHOD OF ACCOUNTING (INCOME TAX REG. SEC. 1.451-3)

We are concerned with the recent proposal announced by The President suggesting the elimination or significant mofdification of the completed contract method of tax accounting, and submit the following comments regarding the possible impact of this proposal.

Arthur Andersen & Co. is an international firm of accountants with offices throughout the U.S. and various foreign countries. While we have many business clients who must operate under long-term contracts and use the completed contract method for tax purposes, these comments are not on their behalf and the views exressed are those of the firm itself.

We oppose major modification or elimination of the completed contract method of accounting.

We believe the adoption of major restrictions on the use of this method of accounting is unnecessary in order to curb alleged taxpayer abuses involving this

method. The Regulations as presently written are sufficient to deal with major abuses of this method by taxpayers.

In addition, we are concerned about this proposal on the grounds that it may (1) adversely affect the financial stability of many companies performing the majority of their business under long-term contracts, (2) increase inflationary pressure, (3) be counter-productive to our renewed emphasis on national defense, and (4) reduce the competitiveness in the industry by forcing smaller and middle size companies out of business.

BACKGROUND OF INDUSTRY

Taxpayers affected by the proposal to modify or eliminate the completed contract method include those companies that are engaged in defense contracts, manufacturing, general building, heavy construction and numerous construction specialties involving plumbing, heating and air conditioning, electrical, roofing and sheet metal work. The taxpayers described above will, hereinafter, be collectively referred to as the "industry."

Available data indicates that the activities of the industry comprise a significant portion of the U.S. economy. Specifically, the industry represents billions of dollars of economic activity, consists of several hundred thousand business entities widely dispersed throughout the country, is the single largest industry employer in the U.S., and contributes a significantly large percentage of income to the gross national product.

The entities which comprise the industry may be distinguished most readily from other industries by their size. In addition to the large, multinational companies who undertake billion dollar contracts there are small, highly competitive businesses which constitute the majority of businesses within the industry and which are engaged primarily in construction. Many of these smaller businesses are relatively cash poor and often require infusions of cash from their owners or from third-party creditors. Therefore, they are vulnerable to economic, competitive and business pressures to a greater extent than the large companies because of their small size.

The significant competition which exists among these small and middle size segments of the industry forces them to narrow their profit margins to an extent not compatible with the risks inherent in their operations. When this factor is coupled with the general lag of receipts for work performed behind expenditures, cash flow problems often become critical. This problem is further exacerbated by present economic conditions such as high interest rates, inflation and labor disputes.

A greater appreciation of the impact of these competitive and economic pressures can be obtained from a review of the recently published Dun & Bradstreet statitstics depicting failures of U.S. contractors engaged in building, heavy and highway construction. Such statistics indicate a 48 percent increase for the quarter ended March 31, 1981 in the number of total failures of these contractors over the number of failures experienced over the same period in 1980.

Another focal point upon which the members of the industry may be differentiated involves the nature of work to be performed under contract with customers. Most of the projects in which contract manufacturers and defense contractors are engaged extend over a period greater than twelve months, and are unique in terms of the specialized needs of their customers. Therefore, in view of the nature of these contracts, several modifications may be required during the course of a project, modifications which create additional costs and burden the already tenuous cash flow positon of most businesses within the industry. Modifications in long-term contracts may also result from technological developments. Particularly with respect to those engaged in defense projects, the state of the art is constantly evolving resulting in the contractor generally having to expend cash for contract modifications, before reimbursement from the customer.

Certain projects undertaken by manufacturers and defense contractors involve the manufacture of custom-made items. This factor often precludes achievement of benefits gained from mass production. Most notably, members of the industry find it difficult to avail themselves of economies of scale which could serve to contain costs of operation.

In addition to the problems experienced by the above-mentioned industry members in performing under a long-term contract, building contractors are confronted with problems unique to the character of their work. Unlike the work performed by manufacturers and defense contractors, the construction activities of building contractors are usually performed at job sites owned by customers rather than at a central place of business. This lack of a controlled environment renders these contractors subject to many delays in completing constructions.

The specific characteristics of the industry as discussed above have a direct relationship on the methods of financing operations. The cost and availability of financing are affected by the unusual risks to which members of the industry are susceptible. One of the greatest risks which confronts the industry stems from the methods of pricing. Essentially, prices are fixed before costs are accurately determined. Therefore, unexpected events which result in additional costs could have a serious effect on contractor profitability. Even in the case of cost plus contracts, not all costs can be anticipated and, in many cases, may not be reinbursable under the terms of the contract.

As a result of the above risks, it may be difficult to ascertain with any degree of certainty the profit or loss of a project on an interim basis. The difficulty in measuring profit on an interim basis has made project financing and long-term financing more difficult than for other businesses.

The following discussion will attempt to indicate that the unique characteristics of the industry support the continued existence of the completed contract method of accounting for tax purposes which is directly related to the economic health of the industry.

DISCUSSION

Contrary to overall economic objectives

The President's dedication to the revitalization of American industry has understandably received a warm welcome and strong support from American business. Of specific note are the Administration's efforts in promoting reduced federal spending, lower taxes, regulatory reform, and a monetary policy designed to control inflation, all of which are viewed by business as necessary prerequisites to any real expansion or our nation's economy.

The revitalization of American industry will require enormous amounts of new capital. This is one of the major factors behind the Economic Recovery Tax Act of 1981. It is generally thought that the major portion of this capital will have to be generated internally rather than raised externally.

In the contracting industry, the problem of securing adequate capital is particularly acute because of the tremendous capital base necessary to rebuild the American industrial empire. The fact that the industry is comprised of many relatively small non-public entities with limited access to many of the conventional sources of capital is also important. The modification or elimination of the completed contract method will place an even greater strain on the industry's ability to generate a level of capital sufficient to support the growth of our productive capacity.

It is important to recognize that it is common for a contractor's cash receipts to lag behind the expenditures he will incur in performing the contract. As a result, contractors invariably require some form of financing to obtain adequate working capital. In addition, most construction contracts (and some defense contracts) have some form of "hold-back" or "retention" provisions. The amount of the hold-back is ordinarily a large part of the profit to be realized on the contract, and many times it will even exceed the total estimated profit from the contract. Most contractors and certain manufacturers are thus faced with the prospect of expending large sums over a period of months (and frequently years) with little possiblility of receiving payments from their customers sufficient to cover the amounts expended on the contract. It is not until full completion of the contract and release of the hold-backs (where applicable) that the majority of contractors realize their expected profit.

Because of these factors and the inherent uncertainty in determining profits on an interim basis, contractors have traditionally elected the completed contract method of accounting for tax puprposes. Eliminating the completed contract method and imposing a requirement for the payment of taxes based on contract performance, the cash receipts of which frequently lag behind a contractor's costs, would significantly increase and complicate the financing burden of many contractors. The further strain placed on a contractor, if forced to finance interim federal income tax payments, as well as his normal working capital requirements, would reduce his capacity to bid on new projects because of a reduced financial base. Whem viewed in this light and in view of financing at today's high interest rates, it becomes apparent that elimination of the completed contract method could severely hamper a contractor's ability to operate and expand.

Given the industry's need for large sums of working capital, a step such as the substantial modification or elimination of the completed contract method which decreases the capital available should be carefully scrutinized to determine if it is consistent with our overall economic objectives.

Furthermore, capital formation is important not only to business growth, but it is also an essential prerequisite to greater employment. Contractors, as a group, may be the largest single industry employer in the United States. Thus, the modification or elimination of the completed contract method will not simply limit a contractor's working capital, but it could also do serious harm to employment conditions in a major sector of American industry which cannot afford the luxury of carrying employees during slack periods.

Recent statements by top Treasury officials suggest that the accelerated cost recovery system and the revised leasing rules have provided a more than adequate subsidy for the business sector. Without question, certain large members of the industry which are very capital intensive will reap major benefits for these changes. But, as mentioned above, a majority of the industry consists of small, localized contractors without a substantial investment in depreciable equipment and property, who stand to gain marginally, if at all, from the changes recently enacted. The benefit of increased depreciation deductions and investment tax credits accrue to the owners of the plant or equipment under construction, and not the contractors themselves. Certain government contractors use government-owned machinery which is not eligible for depreciation or investment tax credits. Thus, although contractors generally will benefit from the new tax bill, the changes may not benefit all contractors to the same extent.

Decline of industry competitiveness

The high degree of competitiveness which has long been characteristic of the industry may be adversely affected by the modification or elimination of the completed contract method of accounting for tax purposes. As described above, the current proposal will place an added financial strain on a contractor's cash flow, which is so essential to his economic well-being. The Dun and Bradstreet report referred to previously confirms that 1980's sharp rise in bankruptcies among contractors has continued in the first quarter of 1981.

The elimination or substantial modification of the completed contract method with its attendant adverse impact on cash flow will only serve to increase the already alarming rate of failures in the industry. Members of this industry, unlike those in most other industries, must set their prices in a competitive bidding or negotiating process which creates continual pressure to reduce profits in an effort to meet competition. Any further material reduction in the number of contractors active in this industry could conceivably upset the delicate competitive balance which historically has functioned to ensure equitable contract prices on new construction.

In the event that the industry does experience some degree of decreased competition, one could reasonably expect to see some escalation in contract prices. This could have an adverse effect on the federal budget in view of the large amount of contract work performed for the government. Thus, instead of helping to control the federal budget deficit, elimination of the completed contract method could eventually worsen the problem by leading to increased federal outlays for defense, highways, public works, and other federal projects and programs.

Inconsistent with Defense Department goals

The elimination or substantial modification of the completed contract method could prove counter-productive to the President's plan of a concerted military build-up. The Pentagon has indicated that it would prefer to buy major weapons systems on a multiyear basis to encourage more defense contractors to make long-term capital investments in plant and equipment. We believe this policy would only serve to expand this country's industrial base in the event a large-scale military mobilization became necessary.

During 1981, in testimony before the House Subcommittee of Readiness, Deputy Secretary of Defense Frank Carlucci stated that productivity in the defense sector of the U.S. economy has been lagging because of relatively low levels of capital investment when compared with U.S. manufacturing in general. The Deputy Secretary identified cash flow problems, tax policy, high interest rates, and low return on investment as factors which tended to limit available investment capital.

Elimination or significant modification of the completed contract method would only serve to further compound the cash flow problems identified by the Deputy Secretary. To the extent higher financing costs are borne by the Defense Department in the form of higher prices for military hardware, the proposal would prove counter-productive to the Administration's goal of increasing our military capability.

Industry risks

Unlike general manufacturing concerns which experience inventory turnover several times a year and collect on receivables within 10 to 90 days, a contractor must generally expend large sums of money over a period of months or years usually prior to the full completion of a project and release of hold-backs. Typically, the costs accumulated in contracts in progress at year-end exceed a contractor's total receipts for the year on contracts completed. It should be also noted that the costs accumulated on a contract, unlike inventory, have little marketability or usefulness except as applied for the purpose of the specific contract. Because of this characteristic, the collateral value for borrowing is severly restricted.

The above facts are sufficient, by themselves, to cause significant cash management problems for contractors. If the completed contract method is significantly modified or eliminated, thereby requiring contractors to pay taxes on premature and possibly uncertain profits, greater working capital would be needed. Since most contractors are in short supply of working capital, they must resort to increased borrowing. At today's high interest rates, the cost of additional borrowing would necessarily be added to the price a customer must pay for the property being developed. Needless to say, these increased prices would in turn have an adverse effect on the containment of inflation and on the economy in general.

Contractors are faced with numerous contingencies which frequently arise during the course of a long-term contract. These contingencies often delay work or require additional investment. One of the most frequently encountered contingencies which affects profits involves changes in the prices of materials during the course of the contract. Other contingencies result from additional costs arising from delays due to strikes, weather, penalties and other such unexpected difficulties.

Uncertainty of profit also occurs due to a lack of a controlled environment. Since the product of each long-term contract is unique because of custom design, contractors are unable to avail themselves of the economies of scale which accrue from repetitive production capabilities inherent in the manufacture of inventoriable goods. Closely resembling this problem are the unique high technology aspects of many projects. Most notable are defense projects. Since technology may not be available or fully tested at the outset of a project, constant exploration, experimentation and development throughout the contract's duration create many additional costs.

A major cause of uncertaintly in determining profits from long-term contracts is their long-term nature. In a fixed price contract, a contractor is required to determine the price for a project prior to incurring costs. Reporting profits during the course of performance could lead to an overstatement of profits upon which income taxes were levied over several years. However, the final completion of the contract could result in an overall loss or a loss due to previously overstated profits.

In cost-plus contracts, a contractor receives a reimbursement for costs he incurs plus a reasonable profit. The major pitfall of this arrangement, however, involves potential discrepancies between the contractor and the customer as to what constitutes a reimbursable cost. Since certain costs are not reimbursable, an overstatement of profits can arise where an unexpected cost is not reimbursable or where the customer contends that an item of cost, not anticipated but ultimately realized, is not to be reimbursed.

It should be readily apparent that any tax imposed on profit before it can be determined with certainly, caused by the modification or elimination of the completed contract method, would be unwarranted. Moreover, it could have a crippling effect on small and certain middle size contractors who are generally cash short, thereby dramatically increasing contractor failures.

Long-standing precedents

Since January 2, 1918, when the Regulations first permitted the use of the completed contract method, the U.S. tax system has recognized the specialized needs of the industry. Essentially, the completed contract method was designed to minimize the effects of the risks inherent from work to be performed over several years. This objective was affirmed by the Internal Revenue Service in Revenue Ruling 70–67, 1970–1 C.B. 117. Therein, the Internal Revenue Service indicated that one of the reasons why contractors are permitted to report income on a completed contract basis was to thwart the impact of changes in the price of articles to be used in construction, of losses and increased costs due to strikes, weather, etc., of penalties for delay and of unexpected difficulties in laying foundations which make it impossible to ascertain with certainty whether a gain or loss was sustained until a particular contract is completed.

Subsequent to the initial acceptance by the Internal Revenue Service of the completed contract method, the industry was able to mature within the framework of

and in reliance upon the availability of this method. Specifically, the industry was able to achieve a high degree of certainty with respect to their tax liability. This facilitated cash management since the need for profit estimates, which usually are highly judgmental and can result in an overstated tax liability, were eliminated. Acceptance of the completed contract method also served to significantly reduce the number of disputes between contractors and the Internal Revenue Service with respect to the computation of tax liability and thus minimized the cost to the Government of collecting tax revenues.

In view of the important role that the completed contract method plays in the success of a contractor's business, any attempt to overturn or nullify this well established method would create uncertainty in an aspect of the industry where certainty currently exists. The immediate consequence would be additional strains on the industry's working capital caused from taxes paid on overestimated profits.

Present law and regulations are sufficient to deal with major abuses

We understand the principal purpose of the Administration's proposal is the eradication of abuses and the removal of obsolete incentives. Though the Internal Revenue Service may perceive abuses in the application of the completed contract method, we believe that the elimination or substantial modification of this method of tax accounting is an excessive means of correcting these abuses.

We believe that any perceived abuses may have been the the result of a misapplication of Section 1.451-3 of the existing Income Tax Regulations, which are adequate to deal with major abuses. We believe that the well-established principles of the completed contract method inherent in our tax system for over 60 years should not be discarded.

In the interests of fairness to taxpayers who may be affected by the proposal, we strongly suggest the use of the following three-step procedure for specifically dealing with the issue of abusive use of the completed contract method of accounting. First, the areas of perceived abuse should be identified by Treasury. Second, as part of the identification of abuses, specific changes to the existing regulations should be proposed. Finally, taxpayers, industry representatives and tax practitioners should have the opportunity to comment on the impact of each proposal. We believe specific changes to the existing regulations may be a proper remedy for dealing with abuses, if, in fact, a commonly accepted practice is an abuse. We further believe the complete discontinuance of the completed contract method would be a classic case of overkill where selective changes are the preferable answer.

SUMMARY AND CONCLUSION

In summary, we oppose the elimination or modification of the completed contract method of accounting for tax purposes based on our belief that such a measure would (1) do serious harm to the industry; (2) create serious uncertainties in the industry which would be adverse to the interests of both the Government and taxpayers; and (3) would be counter-productive to our Country's renewed emphasis on national defense.

We urge the Treasury not to eliminate nor significantly restrict the availability of the completed contract method for tax purposes. The Regulations as they presently exist are sufficient to eliminate any major abuses.

Prepared by: James E. Bushman (513-381-6900), Leader, Firm Practice Specialty Team—Accounting Methods. John Trakselis (312-580-0033), Leader, Firm Industry Tax Specialty Team—Construction and Long-Term Contracts.

L. K. COMSTOCK & CO., INC.,
Danbury, Conn., April 14, 1982.

Hon. DAN ROSTENKOWSKI,
Chairman, House Ways and Means Committee,
Washington, D.C.

MY DEAR MR. ROSTENKOWSKI, L. K. Comstock & Company, Inc., is an electrical contractor involved in major utility, commercial, industrial and transportation projects throughout the country. A pioneer in the Industry, Louis K. Comstock, established the Company in 1904. The Complete Contract Method of accounting has been used by the Company for both tax and book-reporting purposes since its inception.

On learning of the Administration's proposed 1982 Tax Changes, we have thoroughly investigated their impacts on the Company. Our feelings indicate the following:

The use of either the Progress Payment or the Percentage of Completion Methods might result in the acceleration of tax collection, but not in truly new taxes. In fact, the proposed reporting methods will produce less tax dollars arising from the need of additional financing of contracts and the loss of opportunity cost returns from deferred taxes.

The cost of servicing additional debt will be passed to governmental agencies and other owners. The ultimate effect again being decreased tax dollars.

With the need to incur additional debt, the Company would encounter difficulty in securing the support of The Surety and Banking community, which it and all other construction companies desperately need.

Revenue Agents would have the extremely difficult task of auditing either the Progress Payment or Percentage of Completion Methods.

We are sympathetic to the problems faced by the Administration and Congress in dealing with the state of the economy and the projected deficit. It is our belief that the present regulations contain the needed fundamentals to achieve a more timely collection of taxes without any decrease in the ultimate amount of tax dollars.

The Completed Contract Method should be maintained, with reporting required for each defined segment of a contract. This would serve to speed up tax collections and easily lend itself to audit.

It is our desire that the present reporting methods be kept intact since the proposed changes would have a disastrous effect on our Company, the entire Industry, and ultimately on the revenues collected.

Very truly yours,

CHARLES L. SCHARFE, JR.,
Chairman and President.

[NOTE: Letters identical to the above were received from the following officers of L. K. Comstock & Co., Inc.: Richard B. Anderson, Vice President; Joseph R. Dannels, Executive Vice President; Henry A. Dietrich, Vice President; Fred J. Dorsch, Jr., Corporate Vice President; John Halecky, Jr., Executive Vice President; S. P. Valeriano, Vice President, Mid-Atlantic Region; George E. Wrage, Vice President.]

STATE OF CONNECTICUT,
Hartford, March 5, 1982.

Mr. JOHN T. SALMON,
Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Washington, D.C.

DEAR MR. SALMON: I wish to go on record in support of the continued funding at effective levels of two very important economic incentive programs—Trade Adjustment Assistance and Industrial Revenue Bonds.

Both programs are instrumental in helping manufacturers in the United States compete more effectively in the world marketplace. At a time when all of us are interested in the so-called "reindustrialization" process and making America competitive, I believe we must retain the tools to help bring about this worthy and critical objective.

Trade Adjustment Assistance provides an opportunity for industry in import-affected fields to diversify and obtain new markets. It also helps displaced workers who lose jobs because of unfair import practices to secure new training for new employment opportunities.

Industrial Revenue Bonds have been an important incentive to industrial expansion because they represent one of the very few federal contributions to our nation's struggle in competitive world markets. Our manufacturers must compete against companies who are heavily subsidized by their own governments, and revenue bonds have been a source of low-cost capital to help American industry expand and become more competitive.

I appreciate your attention in this matter.

Sincerely,

WILLIAM A. O'NEILL, *Governor.*

STATEMENT OF COOPERS & LYBRAND

Coopers & Lybrand is an international public accounting firm with over 350 offices in 90 countries. We have approximately 800 domestic clients who are involved in one aspect or another of the construction industry. In addition, we have a significant number of clients in other industries doing business on a long-term contract basis.

We appreciate the opportunity to submit for the record this statement on the Administration's tax revision proposals released on February 26, 1982. We will confine our comments to the Administration's proposal to eliminate, by legislation, the completed contract method of accounting for long-term contracts and require taxpayers to elect either the percentage of completion method or the progress payments methods of accounting. We believe that the Administration's proposal to abolish the completed contract method of accounting should not be approved by this Committee.

Present income tax regulations permit special tax treatment for long-term contracts—including building, installation, construction or manufacturing contracts—which are not completed within a single taxable year. Long-term contracts include, for example, contracts to design and build ships, contracts to modify complex equipment to a buyer's specifications, and general construction contracts. They may require more than a year, and sometimes five years or more, to complete.

Income from long-term contracts may be reported by either one of two accounting methods—namely, the percentage of completion method or the completed contract method. The percentage of completion method, based on estimates, recognizes income each year as work on a contract progresses. The completed contract method recognizes income only when a contract is completed and the work or product is accepted. Accordingly, both revenues and costs of contracts in process are accumulated on the balance sheet and no income or profit is recorded before completion and acceptance of the work.

We believe that many companies will be affected adversely if Congress follows the Administration's recommendation and abolishes the completed contract method of accounting. Many of the companies that use the completed contract method of accounting are engaged in substantial projects that employ hundreds or even thousands of people, both directly and through allied industries.

Some industries using the completed contract method of accounting, such as the construction industry, have been damaged severely by the current economic downturn. Eliminating the completed contract method of accounting will further exacerbate an already serious situation for those companies that have managed to survive this period of sharp inflation and steep interest rates.

Moreover, elimination of the completed contract method of accounting proposal will directly contribute to increased inflation. The companies that now use it would experience a sharply reduced cash flow and would be forced to increased borrowings at the current high interest rates. It is impossible to quantify the increase in future contract prices that will result from the loss in cash flow due to the elimination of the completed contract method of accounting. One thing is certain, however, that costs will increase, and the increases could be substantial.

It is extremely important to emphasize that the completed contract method of accounting is not a "tax loophole" as that phrase is commonly understood. Companies using the completed contract method of accounting do not reduce thier Federal income taxes—they simply postpone payment for a period of time.

The principal advantage of the completed contract method of accounting is that it is based on actual results rather than on estimates. Many long-term contracts cover projects with significant contingencies arising from unforseen events. Unanticipated costs and delays and unforeseen problems can sharply reduce or even eliminate profits. We are especially concerned about the elimination of the completed contract method for those contracts where it is impossible to make reliable estimates of completion costs or where inherent hazards make accurate forecasting doubtful.

For example, in such areas as heavy earth moving, tunneling, and dredging, the profitability of a contract is often not determined until the contract is completed. The most expensive part of such projects is frequently the invisible last 10% when unknown rock or other previously undetected natural formations can produce a loss on a contract that earlier appeared to be profitable.

Neither the percentage of completion method nor the Administration's proposed progress payment method can possibly "clearly reflect income" in such cases, and it is quite possible that they might bankrupt a contractor forced to report and pay taxes on illusory profits. The prudent contractor will either not bid on such projects or do so only at a significantly higher cost to the public for assuming such risk.

For over 60 years the Internal Revenue Service has recognized that the completed contract method of accounting "clearly reflects income" for tax purposes. We agree with this viewpoint. If, in certain instances, the election of the completed contract method has resulted in abuses, these abuses should be rectified. We submit that any abuses should be corrected by the Internal Revenue Service through its current regulatory authority and not by legislative repeal of an otherwise appropriate method of accounting for long-term contracts.

STATEMENT OF GEORGE S. KOCH, CHAIRMAN, FEDERAL FINANCE COMMITTEE, COUNCIL OF STATE CHAMBERS OF COMMERCE

The Federal Finance Committee of the Council of State Chambers of Commerce welcomes the opportunity to comment on the President's proposal for an alternative minimum tax on corporations and to recommend reductions in the 1983 fiscal year budget.

In summary, our recommendations are as follows: 1. The proposed new minimum tax on corporations should be rejected because its adverse impact on several basic industries and new growth companies would retard economic recovery. 2. Existing inflation indexing of entitlement programs, incluing Social Security, should be revised to curtail the rapid growth of their costs. 3. The projected high growth rate of defense spending should be reduced.

MINIMUM CORPORATE TAX PROPOSAL OPPOSED

A year ago we strongly supported the President's tax proposals which had the basic purpose of encouraging savings and investment by individual tax reductions and by more rapid recovery of capital investments than under then existing depreciation rules. These tax reductions and revisions were enacted in the Economic Recovery Tax Act of 1981 substantially as proposed. The Act also includes additional tax relief provisions deemed desirable by the Congress.

With the economy in recession and several basic industries in a severe slump, this would hardly seem an appropriate time to increase taxes. Of particular concern to us is the proposal for an alternative minimum tax on corporations. The Treasury estimates that total corporate tax liabilities will be increased 5 percent by the tax. But this additional tax burden will be borne by only 90,000 corporations whose taxes would be increased an estimated $2.3 billion in fiscal year 1983, $4.8 billion in 1984 and $4.5 billion in 1985.

Especially affected by the minimum tax proposal would be such depressed basic industries as automobile, mining and steel which would lose much of the benefits of the 1981 Act with respect to investments being made to improve their productivity. Also affected adversely would be emerging growth companies having relatively little taxable income under present law and needing all available cash flow for growth. Imposing new tax burdens on these depressed industries and new growth companies would only retard resurgence of the economy. We urge rejection of the corporate minimum tax proposal which would retard growth of budget revenues as well as economic recovery.

EXPENDITURE REDUCTION AND CONTROL

The Congress last year made substantial progress toward bringing Federal spending under control. But much more needs to be done. Projected outlays in three spending categories are of particular concern because of their size and rapid growth. They are entitlements, national defense, and interest.

According to baseline outlay projections of the Congressional Budget Office (CBO) benefit payments for individuals, which are almost totally entitlements, account for 47 percent of estimated 1982 total outlays and they will increase 29 percent by 1985 under present law. It is this category, of course, which is a primary concern of the Committee on Ways and Means since a major part of total entitlement outlays are within your jurisdictional responsibility.

In our appearance before your committee and the Committee on Finance last Spring we urged consideration of means for restraining the cost impact of existing inflation adjustment on various entitlement programs. It is these adjustments which have been the major cause of the sharp increase in their cost in recent years. A number of methods for accomplishing this restraint have been proposed. For example, the budget plan proposed by Senator Hollings would reduce outlays for Social Security and Federal retirement programs by an estimated $19 billion in 1983 and $37 billion by 1985. It would freeze the COLA for these benefits in 1982, cap the Social Security COLA at the consumer price index minus three percentage points for subsequent years, and limit the military and civil service retirement COLA at the lower of the Social Security COLA or the Federal pay raise percentage.

We again urge your committee to revise indexing of entitlements under your jurisdiction, including the inflation indexing of Social Security benefits, to produce multibillion budget savings in the years ahead.

We do not claim competence to suggest any specific amount of reductions in national defense programs at this time, and we recognize that this is a matter under the jurisdiction of other committees of the Congress. But, in view of projected huge

budget deficits for several years to come, we do wish to express our concern over the projected growth of defense spending. For example, national defense outlays projected in the 1983 budget would rise from $187.5 billion in 1982 to $292.1 billion in 1985 for an increase of 56 percent in three years. A further increase of $72 billion, or 25 percent, is projected from 1985 to 1987. Unless inflation is brought under control in this period, the planned defense program would cost even more. While we are not in a position to recommend specific program reductions, we do believe significant cuts could be made without seriously impairing the nation's defense.

The growth of interest costs during the next few years will be largely determined by what Congress does about reducing budget deficits. Net interest costs in the 1983 budget are projected to vary relatively little during the 1983–87 period from the $96.4 billion estimate for 1983. The CBO baseline projections, however, show net interest at $106 billion in 1983 and rising steadily to $168 billion by 1987.

Deficits projected in the 1983 budget would decline gradually from $91.5 billion in 1983 to $53.2 billion in 1987. But the CBO baseline deficit projections, which are based on existing legislation and CBO economic assumptions, show the deficit rising from $157 billion in 1983 to $248 billion in 1987. Actions taken to reduce the projected deficits in substantial amounts would have a twofold effect in reducing interest costs. In addition to the obvious reduction in projected interest costs that would result from the smaller than expected public debt, reducing the deficits would help to bring interest rates down. This would occur with reduction of the present large inflation premium in interest rates, especially in longer term rates, as lenders' anticipation of future inflation recedes.

In conclusion, we urge the Committee on Ways and Mens to reject the proposed minimum tax on corportions because of its adverse effect on several major depressed industries, and to revise the indexing of entitlement programs, including Social Security, to provide substantial budget savings. We also urge your support of some slowdown in the administration's planned growth of defense spending.

STATEMENT OF COUNSEL FOR COMMUNITY DEVELOPMENT, INC., BY BELDEN HULL DANIELS, PRESIDENT, NANCY BARBE, AND STEVEN KLEIN

PRESERVING UMBRELLA REVENUE BONDS OR UMBRELLAS: ESSENTIAL FOUL WEATHER GEAR FOR SMALL BUSINESS

Counsel for Community Development, Inc. is a firm specializing in development finance and economic development in this country and overseas. Since its founding by Belden Hull Daniels in 1971 the firm has been active in urban and regional economic development activities at the federal, state, and local levels in North America, Europe, and Third World countries. In recent years the firm has been a leader in the design of strategies to promote small business enterprise, financing of local development organizations, innovations in the regulation of capital markets, and other public development finance activities. The authors of this report are Belden Hull Daniels, Nancy Barbe and Steven Klein.

National attention has recently turned to a key tool of state and local government economic development policy—the industrial revenue bond or IRB. Focusing on their use by companies that do not need low-cost capital, their use for non-essential purposes and their high cost to the Federal Treasury, criticism has coalesced around the cry (as Barrons stated in an August 1981 editorial) to eliminate "corporate food stamps." While valid criticisms can be made of many IRB programs operated by state and local governments across the country, IRBs can be an effective economic development tool when targeted to worthy firms and communities that would otherwise have little access to capital. The umbrella revenue bond (URB) is one innovative program that targets tax-exempt capital to small firms by pooling many small loans into one bond issue. URB programs have been run by several states with great success. Firms assisted with URB programs have by and large been industrial firms with high job-generating potential; those with less access to capital through traditional bonding procedures; and those with a true need for the low-cost capital available through the tax-exemption of interest rates. When amending federal regulations for IRBs, Congress should deal firmly with the obvious abuses of the program while attempting to maintain well-designed programs that have developed out of the tax-exempt option. URBs are a tool that should be saved—umbrella are truly essential foul weather gear for small business.

The current debate over IRBS: Uses and Abuses

The industrial revenue bond was first used by the state of Mississippi in 1936. From 1959 through 1968 six states (Alabama, Arkansas, Georgia, Kentucky, Mississippi and Tennessee) accounted for 87 percent of all IRB issues and 60 percent of all

IRB dollar volume. The explosion came in the seventies. Forty-seven states now authorize the issuance of tax-exempt IRBs. The volume of IRBs issued has increased dramatically: a recent Congressional Budget Office study found that from 1975 to 1980 IRB offerings jumped from $1.3 billion per year to $8.4 billion per year. Geographic use of the bonds has also changed; states in the Northeast and Midwest are now the major users. In 1979 the four largest IRB issuers—Minnesota, New Jersey, Ohio and Pennsylvania—accounted for 45 percent of total IRB financing in the country. While a portion of the increase in dollar amount can be attributed to inflation, it is nonetheless true that a significant increase has occurred in the use of IRBs.

The major interest in controlling the issuance of IRBs emerged at the federal level as part of attempts to limit federal government revenue shortfalls. The House Ways and Means Committee originally examined curtailment of IRB use as a way to raise federal revenues and thereby decrease the need for Administration spending cuts in order to balance the federal budget. The Committee asked the Congressional Budget Office (CBO) to analyze the costs and benefits of IRBs from the federal standpoint. The resulting study found that the projected cost to the federal government of IRBs as currently used could rise as high as $4.4 billion by 1986. This fact received widespread attention in the media and from policymakers. What was noted less often, however, was an additional projection by the CBO that if all IRBs were eliminated on July 1, 1981 the net revenue gain to the Federal Treasury would be only $.2 billion in 1982 rising eventually to $.7 billion in 1986. These figures must be considered in light of a total 1982 federal budget of $695 billion to accurately assess their importance.

Many analysts have argued that the CBO analysis does not accurately assess the indirect economic benefits to the Treasury (e.g., increased revenues from payroll taxes, sales taxes, additional corporate taxes from business expansion) and inaccurately assumes that all IRBs, if eliminated, would be replaced with taxable loans. A study recently published by the University of Chicago Business School which included these adjustments concluded that the actual loss to the federal government from IRB programs is about one-sixth the level estimated by the CBO.

The fervor to control IRB issuance has been fanned by the highly publicized abuses of the program. Indeed, if the abuses of IRB programs were not so blatant, few policymakers would be so intent on eliminating them for their relatively small contribution to federal government expenses. Barrons recently noted that Moody's listing of recent offerings of IRBs read like the Fortune 500—firms that can hardly be described as having a justifiable need for federally subsidized interest rates. IRBs have been dubbed "burger bonds" due to their widespread use by McDonald's. The June 1981 Moody's Bond Survey listed $11.4 million in IRBs bearing the names of 21 industrial development authorities in Colorado, Indiana, Michigan, Missouri, Ohio, Pennsylvania and Tennessee—all for the development of new McDonald's restaurant facilities. The number of net new jobs that will be generated in any of these states by McDonald's restaurants is extremely limited. "Sixty Minutes," the television newsmagazine, recently publicized the request of its parent company, RCA Victor, for an IRB in the amount of $10 million to finance the expansion of its offices in Washington, D.C. In November of 1980, merchants in Ravalli County, Missouri defeated a referendum to issue a $4 million IRB to finance a K-Mart shopping center on the outside of town. This was only a minor setback for K-Mart, however: it, along with McDonald's, are the two largest single corporate beneficiaries of IRBs. As many have noted, both corporations apparently believe that they "deserve a break today."

The list of abuses continues on from non-needy firms to non-essential, non-development oriented uses. Racquetball courts, massage parlors and country clubs have all benefited from IRBs. Few would be able to justify the issuance of IRBs to these enterprises even under the broadest definition of the "public purposes" that all qualifying firms must fulfill to receive the federal tax exemption.

While these three arguments have preoccupied the popular analysis of IRBs, there are other more theoretical concerns. Analysts have stated that the large volume of IRB issuance has raised the cost of municipal borrowing, as the market for traditional tax-exempt investors has become quite crowded, forcing tax-exempt borrowers to offer higher and higher interest rates to appeal to investors in lower-income and tax brackets. Philosophical arguments have also been raised about both the appropriateness of public subsidies (in the form of an interest rate reduction) granted to private enterprise and the unfair competition they create for firms that do not use them.

Umbrella revenue bonds: a well-designed tax-exempt innovation

The list of problems with current IRB programs is substantial and many of the criticisms are sound. In the course of amending federal regulation of IRBs, however, the seriousness of these criticisms should not be allowed to sour the assessment of sound IRB programs and innovations—programs where the tax-exempt status of IRBs is an invaluable tool for economic development.

Umbrella revenue bonds (URBs) are one such invaluable tool. An umbrella revenue bond is a single note, issued much like any other industrial revenue bond. The difference between URBs and IRBs is that while an IRB will be issued with the total proceeds going to a single firm, subunits of the proceeds of a single-issue URB are lent to a variety of firms that stand behind the bond. In effect, the URB issue is a diversified loan portfolio.

The design and structure of a URB eliminates many of the problems and abuses that have occurred with IRBs. URBs make money available to small businesses. Many studies have documented both the important role small businesses play in the national economy and the relatively difficult time they have acquiring capital. Thus, by directing capital to small businesses, URBs fill a financial need of this important sector and help insure its viability.

URB programs have by and large been designed with stricter requirements than IRB programs have had. The fact that a URB is made up of many smaller loans necessitates the presence of a statewide industrial finance agency that has access to a large volume of loans from which pools can be established. The state agency also must have the technical capability to design and administer the program. In contrast, most IRB programs are administered at the local level. The presence of this statewide, professional URB agency ensures that qualification guidelines and targeting of URBs can be more strictly and efficiently enforced. As a result, URBs have tended to go almost exclusively to manufacturing concerns and other "essential uses" that contribute directly to the economic development of a locality or region.

Finally, the pooling of smaller loans into a single URB presents specific benefits to both borrowers and investors.

Smaller firms are given access to capital from the bond market. The $1 million plus size of a typical IRB issue is both too large for a small firm to carry and larger than many small firms need.

The actual cost to the firm of raising capital is reduced. The cost of issuing a bond is fairly constant, regardless of the size of the bond. Consequently, the disproportionately high cost of issuing bonds of less than $1 million prohibit their issuance. With a URB, instead of issuing many small bonds with high proportionate issuance costs, a single larger bond is issued decreasing issuance costs to a level that is bearable by the smaller firm.

URBs decrease the cost to the investor of collecting information on the individual firms. By pooling many small loans into a single bond issue that is large enough to qualify for a rating, the investor receives a standard evaluation of the quality of the bond. Without a URB, the investor would have to research the financial position of each individual firm with high cost in terms of both time and money—and would typically opt to not even consider making the investment.

By creating a diversified pool of individual loans, a URB decreases the risk borne by the investor. With a URB, investors purchase a small part of many individual loans, rather than placing their money all in one loan. By pooling in this manner, the risk assumed is reduced below that which would be assumed if the investor purchased the loan of any individual firm within the URB package. The reduced risk makes the investment more attractive to more individuals and consequently increases the capital available to these businesses.

Thus, URBs perfect the IRB mechanism in many ways. They are clearly an innovation that should be separately examined in the IRB amendment process. Further, regardless of the outcome of that amendment process, URB programs should be saved. Unfortunately, URBs already face problems beyond those generally faced by tax-exempt bonds. On August 24, 1981, the IRS issued Revenue Ruling 81-216, which bars the pooling of small business loans into tax-exempt bonds for sale in secondary markets. The ruling is a particularly negative one in that it eliminates the URB—one of the most innovative tax-exempt mechanisms used—while doing nothing to address the many problems and abuses found in the IRB market. Efforts are being made to have the ruling withdrawn: the Coalition of Northeastern Governors, the Midwestern Governors' Conference, the Western Governors' Conference and the Western Governors' Policy Office have all formally requested President Reagan to revoke the ruling. Nonetheless, much damage has already been done: several state agencies have had to cancel URB issues that were ready to go to market with a resulting loss of jobs and economic activity. For example, the Maine Guarantee Au-

thority was ready to go to market with its first URB for $7.5 million. The issue was killed by the IRS ruling. A small agricultural products company was to receive a $200,000 loan from that URB for new building and machinery. The absence of that loan has already resulted in the elimination of 15 jobs at the company. These are jobs that the Maine economy cannot afford to lose.

URBs face threats on two fronts: from the Congress and the IRS. We urge the Administration to rationalize its stand on the tax-exempt issues. Abuses of IRBs must be eliminated while sound innovations are preserved and strengthened. The IRS's treatment of all types of tax-exempt issues must be modified to support Administration goals. Action should be taken quickly: the longer there is a lack of clear policy the more hesitance there will be in the tax-exempt bond market. Further, and more urgent, the longer the IRS ruling stands, the more jobs and economic activity generated by small firms will be lost.

URB programs: successful operating models

Umbrella revenue bond programs are now authorized in at least eleven states: Alaska, Connecticut, Maine, Maryland, Massachusetts, Michigan, Nevada, New Jersey, New York, Ohio and Pennsylvania. Several of the programs have little operating history: like Maine, their initial URB issues have been cancelled due to the IRS ruling. To present a more thorough picture of the importance and success of umbrella revenue bond programs, we will briefly review the program of the Connecticut Development Authority which has one of the longer standing URB programs.

The Connecticut Development Authority

The Connecticut Development Authority (CDA) was created in 1973 by the state for the purpose of stimulating industrial and commercial development and employment within the state. The CDA's Umbrella Revenue Bond Program is designed to make financing available to small, high-risk companies which would not be able to qualify for typical "self-sustaining" industrial revenue bonds backed only by the firms' own credit. The CDA can issue "umbrella bonds" in its own name to assist firms in acquiring land, buildings, machinery and equipment, and pollution control facilities. The use of CDA's name reduces investor information costs. Loan limits are 25 years and $850,000 per industrial project. CDA will not lend more than 90 percent of either the project's cost or its appraised value, whichever is lower. Overall, the umbrella program is authorized to have a total of $200 million in outstanding bonds.

In 1980, CDA sold $37 million of bonds in a single multi-series offering. In the fiscal year ending June 30, 1980, the Authority approved 123 umbrella program loans totalling $47.6 million. The average size of these approvals was $387,000. The number of loans actually closed by the fiscal year end was 53. A small sample of CDA umbrella program loans gives a good picture of the type of businesses that benefit from the program. Almost all firms financed with CDA umbrella loans are small: the average number of employees in the firm before the loan is approximately 22, the average total assets are $516,000 and average sales are $1,186,000. The average age of firms is 22 years, but firm age ranges from 4 years to 73. Ninety-five percent of all umbrella loans went to businesses in the industrial/manufacturing sectors, with the other five percent were used for office construction.

Initially, the CDA umbrella program provides funds to companies through bond anticipation notes drawn on the Authority's own bank credit lines which total about $30 million. The interest rate on these notes, which are tax exempt, is about 60 percent of the prime lending rate. To date, rates have ranged from about 8 to 11 percent. The notes are used until the long-term revenue bonds are issued, which may be a period of several months. The Internal Revenue Service limits the size of the small industrial revenue umbrella issues to $1 million per borrower.

In the past, CDA pooled loans to several firms scattered across various industries and parts of the state into a single issue. Recent practice, in light of a 1978 IRS ruling on small industrial revenue bond issues, has been to sell separate umbrella bond series, sometimes for less than $100,000 for each project. By doing so, the capital borrowing capacity of a company or a municipality is not reduced by unrelated projects included in the same bond.

Each CDA umbrella bond series is sold simultaneously in a batch composed of dozens of others, all being issued under the Authority's name. Since the first umbrella bond offering in 1975, CDA has gone to the market three times. By selling all the issues at one time, CDA is able to spread the underwriting costs among all the borrowers.

The CDA itself receives no state funding. Its main sources of revenue are loan application and acceptance fees from bond sales. In addition, the Authority charges

borrowers an incremental 0.5 percent above its own cost of money. One of the state's impacts on CDA is its authorization that some fees to CDA be waived for firms operating *in economically de*pressed areas. Additionally, in the event that accumulated reserves are depleted by loan defaults, CDA has standby authority to "fill up" by issuing general obligation bonds in the name of Connecticut.

STATEMENT OF GEORGE W. CREGG, C.I.D., CAMILLUS, N.Y.

INTRODUCTION

Alexander Hamilton in the New York Packet, Tuesday, January 1, 1788, wrote. "In disquisitions of every kind, there are certain primary truths, or first principles, upon which all subsequent reasonings must depend".

On another occasion in the Federalist Papers he stated: "The individual States should possess an independent and uncontrollable authority to issue their own revenues for the supply of their own wants."

The Federalist system endorsed the doctrine of reciprocal immunity. "The powers not delegated to the United States by the Constitution or prohibited by it to the States, are reserved to the States respectively, or to the people" Article The Tenth, Constitution of the United States.

Under the New Federalism of 1982, powers and responsibilities ursurped over the last 50 years of wars and social change should be legally returned to the States.

GENERAL COMMENTS

Hamilton said, *"Men, upon too many occasions, do not give their own understandings fair play;* but, *yielding to some untoward bias,* they *entangle themselves in words and confound themselves in subtleties".* (Emphasis our.)

The Treasury Department's General and Technical Explanations of Tax Revisions and Improved Collection and Enforcement Proposals contains an abuse of "fairplay" and "untoward bias" that would have shocked Hamilton in spite of his strong preference for a national instead of a federal government.

The section entitled "Tax-Exempt Bonds for Private Activities" is cleverly written in a manner used by many lawyers in writing pleadings and briefs designed to prejudice a court or jury by the use of "labels", "catch phrase", "unfounded conclusions", "spurious assumptions", etc. While I have great respect for the Federal Treasury Department's tax collecting ability, tax policy and economic policy should be made by the Legislative Branch of our Government subject only to the veto of the President. The laws implementing that policy should be interpreted by the Judicial Branch, and enforced by the Executive Branch. Under such circumstances, a report to the Congress such as this document should state unprejudiced facts without the intentional use of emotional and biased words or phrases. The Congressional Budget Office report was fairly entitled "Small Issue Industrial Revenue Bonds" and released April 1, 1981 and prepared under the CBO's mandate to provide nonpartisan analysis with "Policy Alternatives" and "Policy Goals"; not the unfair biased "Proposal Limits" contained in the subject section. The Treasury should have entitled this section "Industrial Development Bonds" and not "Tax-Exempt Bonds for Private Activities". The "public purpose" behind the continuance of the constitutional right of States and their subdivisions to issue Industrial Development Bonds is to encourage the economic development of the whole United States. The exemption from taxation of the interest on such bonds under qualifying circumstances provides not only an incentive for the retention and creation of jobs, but also acts as a strong incentive to modernize the backbone of our small (10 million is small—one U.S. Army tank costs over 2 million) industrial plants, and revitalize our urban areas. The use of the phrase "Private Activities" ignores the "Public Benefit" nature of such financings in bringing about the expansion and development of the economy.

Under the section subtitle "Reasons for Change" (which assumes there are such reasons "for" and none "against"), highlights a growth erroneously perceived as "bad" rather than "good". The growth is good and is a barometer measurement of an improvement in the economic climate. In the second sentence of this subtitle, the "largest growth" is stated to have occurred "in small issue" IDB's; implying the "largest" is the "worst". This growth should be no surprise to the Treasury which has successfully blocked the ability of small business to borrow conventional loans at "reasonable" rates. Treasury obligations issued in great volume in the last few years has skyrocketed interest rates. Reduce federal borrowing and reduce federal spending, let interest rates drop to 6 to 8 percent (7 percent is prevalent in Japan) and small business will return to the conventional market.

The national rate of delinquency on payments on loans from the Farm Home Administration is now at 58 percent. If you restrict the right of a State agency to issue industrial development bonds, instead of small business expansion you will have small business collapse. Farmers and other who in the past have sought small business jobs in manufacturing during agricultural recessions will have no place to find work. Students graduating and other youths will have no productive future. Welfare expenses and the costs of crime will increase.

The nation's economy is extremely fragile and cannot stand tinkering. Henry Kaufman, well known economist, testified before the House Committee on the Budget on March 16, 1982: "In closing, I again want to urge you to implement economic policies that will deal effectively with the gravity of the business and financial situation. *Patchwork policies will not resolve our problems. Basic reforms in both fiscal and monetary policies are needed.* Without them, not only will sustainable economic recovery elude us but greater economic risks may be the consequence." (Emphasis ours.)

As Mr. Kaufman pointed out, the credit needs of our Federal Government are now at 28 percent of the credit market; almost 5 times the demand of the comparable 6 percent in the 1950's and 1960's. Assuming a current inflation rate of 8 percent, Mr. Kaufman said "the real rate of return is now about 800 basis points for high-quality corporate bonds—a postwar record", and indicated that in the 1960's and 1970's "these returns averaged only 275 and 206 basis points, respectively". Mr. Kaufman said, "High 'real interest rates' are dangerous to the seriously weakened financial structures in the private sector . . ." Some of our big energy companies can still go to the credit market and obtain sufficient money to speculate in huge mergers; money is still available if the risk is small and the borrower is willing to, and can, pay high interest rates. The availability of money is recognized in the last sentence of this subtitle, just before the "Proposal" subtitle with this statement "they are able to raise funds readily in capital markets". The Treasury does not add "at 16 percent".

The relatively small businesses need tax-exempt rates in order to obtain the money needed to modernize our industrial complex. The fourth sentence in the subtitle "Reasons for Change" indicates the sale of IDB's "affects the market for tax exempt securities as a whole" when the Treasury well knows the real problem is the 28 percent credit demand of the Federal Government, and not the "minimal affect" of small issue IDB's in the competition for "traditional private corporate capital" which is always expanding. The competition is not with "traditional municipal bonds". In my humble opinion, one month of "all-savers" certificates would have more effect on the municipal credit market than all the small issue IDB's issued to date. Numerous other laws including Glass Steagal, and foreign tax credits have very serious effects on the "traditional municipal" credit market. One unmentioned fact in this subtitle on influencing all interest rates is the unpredictability of Federal monetary policy.

The viability of Industrial Development Bonds is recognized throughout the United States. These Bonds have proven to be the best and most useful tool available for the industrial and any other kind of economic development. If we want to expand and modernize, if we want the kind of capital investment that will compete in today's world markets, we must start by keeping the few incentives that are working. Let the States continue their work unhampered. It is good for our States' economies and for our Nation's economy. It will be good for the economy of the free world. The tax exempt feature of IDB's not only upholds the relationship of State and Federal Governments mandated by our Constitution, it promotes fiscal independence of the States. Local units of government have always been closer to the people and are in the best position to determine their own public policies. States should be allowed to continue to use IDB's to pursue these goals.

The great State of Massachusetts through its Massachusetts Industrial Financing Agency recently completed a study which surveyed 800 of the bay State's firms that have issued more than 1 billion in IDB's since 1978 and found these bonds contributed greatly to the ability of small companies to expand. The results were certified by a nationally known accounting firm. More than three-quarters of the firms assessed had sales of less than $20 million while almost half were under $5 million. 93 percent of the companies said they would have been forced to alter their investment plans in IDB's were not available. 33⅓ claimed they would have cancelled their expansion plans; nearly another third said their expansion would have been delayed; ⅛th said their project would have been slashed; and 5 percent said they would have located in another State. The incentive is to modernize and expand; not locational.

In October of 1981 a similar, study was completed on the "Primary and Secondary Impacts of IDA Financing on the Long Island Economy". The Long Island study

concludes, as follows: "The Federal government, through IDA financing, can make a major contribution to the growth and viability of the Long Island economy. Based on IDA bonds issued during the 1980–81 period, the Federal government would lose $48,993,250 in interest foregone on IDA bonds issued in Nassau and Suffolk counties. However, the Federal government would gain $396,096,610 in income taxes on direct jobs created and $1,188,221,526 in income taxes on secondary jobs created over a ten-year period. In addition, there would be substantial increases in state income taxes, in state and local sales taxes and in local property taxes".

In 1976 a study was prepared for the American Industrial Development Council (now the American Economic Development Council, Inc.) by Dr. John A. Andrews and Dr. Dennis R. Murphy of Emory University entitled "The Interest Tax-Exemption on Industrial Development Bonds: The Cost To The United States Treasury" which reached substantially the same conclusion as the recent Long Island survey. The Emory University study stated as follows: "The issuer is not the only party that benefits from the issue of the securities. Since the primary use of the funds is to acquire or improve depreciable property, there will be an economic benefit to the related trades that support the depreciable property in the form of wages, salaries and so on. Beyond this initial stimulus, there is a long term benefit to the immediate area in the form of creation of jobs, resulting in wages, salaries and commissions that in turn create additional activity".

Furthermore the Emory University study concluded: "It is clear from the foregoing analysis that previous studies have seriously overstated the net costs to the Treasury because of the tax-exempt interest payable on the IRB's. It is very difficult to argue for the removal of the tax exemption on IRB's on the grounds of the cost of the Treasury in terms of foregone tax revenues."

Dr. Norman B. Ture, in his 1980 study "Economics and Federal Revenues Effects of changes in the Small Issue Industrial Development Bond Provisions" noted that projection of a revenue loss are based on the unrealistic assumption that there are no changes in economic activity in response to a tax change, and concluded that the Federal government would receive a significant revenue gain from increased use of IDB's based upon the increased capital formation with the secondary gains in output, expansion of corporate tax base; and increased individual FICA and income taxes, and corporate payroll taxes. He concluded that increasing the "capital expenditure limit" on IDB's "would generate net gains in tax revenues for the Federal government and for the state and local governments of the issuing jurisdictions."

The New York State Economic Development Council in 1981 undertook its own study of IDB financing in New York State. This study is still under way and is not yet complete. An interim report reviewing replies from 33 of the State of New York's Industrial Development Agencies concluded: "The majority of IDA's do not believe the present bond limit is satisfactory but not all agree on what the limit should be. Eight IDA's though the limit should be $20 million."

ANALYSIS OF TREASURY PROPOSALS

Proposal (1)

There is no need for any such proposal in New York 'State. The New York State Industrial Development Agency Act clearly defines "public purpose", all meetings of the Agencies are subject to the State's Open Meetings Law", a majority of all the authorized members must act to approve a bond issue, and the members are "appointed by the governing body of the municipality" and shall serve "at the pleasure of the appointing authority". New York's Industrial Development Agencies are well run and adhere to "public purpose" financings. Only 2 small issues have gone into default in over 12 years, and over one and one-quarter billion in financing. The small businesses of New York State have truly been served, and the public purpose of creating and retaining jobs has been fulfilled. Approvals of the elected officials would create serious problems regarding possible individual or municipal liability.

Proposal (2)

New York State's Constitution prohibits gifts or loans to private enterprises. New York would have difficulty with this proposal. On the other hand, New York does allow a long list of tax advantages to industry and business without discriminating as to whether the company involved is seeking tax exempt interest. However, it should be noted that the interest on IDB's is totally tax exempt in New York State with no capital expenditure rule. Most projects are exempt from Sales Tax. The real property is tax exempt though payments are usually made in lieu of taxes. There is no personal property tax in New York State. To require more would be unfair to New York.

Proposal (3)

To require 35 year "extended" life straight line depreciation is obviously proposed to wipe out IDB financing and totally unfair.

Proposal (4)

No change is needed to "help" small businesses in this regard. The Congressional Budget Office report indicates "only 16 percent" of such financings were for Fortune 1000 or 50 companies, and 84 percent were small business.

Proposal (5)

Tlhe newest trend in order to react to the lingering recession is to pool resources, and to start up (1) industrial condominiums in urban areas and (2) small industrial parks in suburban and rural areas. To do this requires composite letters of credit and guarantees. Proposal 5 discriminates against small business at one of its most recent darkest hour.

Proposal (6)

Registration will increase the cost of issuance, cost of operation of Agencies issuing agencies and result in still higher interest rates. This proposal also discriminates against small business. In New York issues are reasonably and accurately reported to the New York State Department of Commerce even though there is no requirement to do so.

Proposal (7)

The present arbitrage regulations are difficult enough to comply with. The typical New York project has no "reserve fund". However the difficulty of calculating and planning a "zero return" on a temporary construction fund would be impossible. Any such requirement would severely complicate an already expensive procedure and again discriminate against small business in New York State.

Proposal (8)

No comment.

CONCLUSION

America as a nation is dying on "old age". Our infrastructure is decayed. Our bridges, highways and other public facilities are falling apart. Eighty percent of our industrial establishment is operating in 30 to 40 year old buildings. Many of our industrial workers are using World War II machines and tools.

Hiroshima has been largely rebuilt twice since the atomic bomb was dropped. We have been lost in lethargy, cliche attacks on "big business", and rampant regulations and restriction of all business.

As an industrial and economic developer, I know the tools that are useful for modernizing our economy. I am not a theroist.

Industrial Revenue Bonds are under attack because of a mistaken idea that only big-name rich companies benefit at the expense of the taxpayer. The use of a few well known trade names, the listing of a few "abuses" and totalizing volumes of dollars all make for sensational press headlines. However, as responsible representatives of the citizens of our communities, our States and our great Nation, we must examine the true facts in assessing best approach to our rapidly declining position in the World's economy. The economic war between the States is almost over. While a few small areas of our nation are experiencing old fashioned "prosperity". double-digit unemployment is pervading almost every other corner of our great Unted States, we must act in a very positive way to seek out the causes of our weakening economy. Our close friends in West Germany and Japan have built modern industrial empires. The communist countries are moving at a relatively slow pace, but they started their "five year programs" of economic expansion from scratch and have been maintaining enormous military budgets. The biggest threat to our economic future is from the middle east. They will be our "friends" as long as we buy their oil, and "subsidize" both their economic development and military budgets.

Richard Henry Lee, author of the resolution of June 7, 1776 calling for independence from Great Britain is known to have said that our great U.S. Constitution was "calculated ultimately to make the states a consolidated government." Patrick Henry supported Lee's belief. The spirit of President Reagan's "New Federalism" is the return of control in fiscal matters to the States.

Alexander Hamilton under the pen name of "Publius" aptly said: "Every thing beyond this must be left to the prudence and firmness of the people; who, as they will hold the scales in their own hands, it is to be hoped, will always take care to

preserve the constitutional equilibrium between the general and the State governments. Upon this ground, which is evidently the true one, it will not be difficult to obviate the objections which have been made to an indefinite power of taxation in the United States".

We have faith in our Senators and our Congressmen as representatives of the people and believe that they will follow the great leadership of our founding fathers in upholding the Constitution and in legislating on a fair and unbiased basis.

Industrial Development Bonds are needed now, more than ever, to save our small business and to keep our economy from disaster.

DADE COUNTY,
INDUSTRIAL DEVELOPMENT AUTHORITY,
Miami, Fla., April 6, 1982.

Representative DANTE B. FASCELL,
Rayburn House Office Building,
Washington, D.C.

DEAR REPRESENTATIVE FASCELL: We are informed that the Senate Finance Committee will soon consider proposals and legislation designed to reduce the federal budget deficit and will almost certainly include revision of present guidelines governing the use of tax exempt Industrial Revenue Bonds (IRBs). Your past concern and informative updates on this issue is sincerely appreciated. I would like to encourage your continued diligence and pass on suggestions which this organization hears increasingly voiced within our industrial community and by other organizations around the state also responsible for promoting economic development.

Many similar economic develcpment organizations acknowledge that the vagueness of present federal regulations concerning IRBs has led to their increased use for purposes perhaps not originally intended by Congress resulting in an increased drain on federal revenues. It is unfortunate that many alledged abuses, i.e. massage parlors, private sports facilities, etc., have overshadowed the many genuine economic benefits that have been made possible by this financing vehicle.

The Administration's proposal, placing severe across the board restrictions on all IRB fiancing is felt to be overly reactive, whereas the targeting of IRBs to traditional industrial uses with commercial ventures permissible in designated economically distressed areas will accomplish a substantial portion of the Administration's goal in reducing the volune of tax exempt debt. At the same time, IRBs will continue to provide for new employment oppoprtunities and encourage the modernization of U.S. industry necessary to compete more effectively in the World Market Place.

In recent Senate Finance Committee hearings, Senator Dole requested suggestions revising present IRB regulations, and providing for assistance in raising revenues. Specifically, the Dade County Industrial Development Authority recommends:

Restrict the use of IRBs to traditional industrial purposes, i.e. manufacturing, assembly, processing, warehousing and distribution with commercial ventures permitted within designated economically distressed areas.

Permit the use of IRB financing for above purposes in conjunction Accelerated Cost Recovery or alternatively, such depreciation methods as were in existance prior to the enactment of the 1981 Tax Act.

Require public hearings, findings of public purpose and approval by a publicly elected body prior to the issuance of bonds.

Require annual reporting of all bonds issued to the Treasury Department.

Other provisions of the Administration's proposal will present formidable fiscal and constitutional compliance problems for Florida and are not recommended.

Your continued assistance in communicating these concerns to your colleagues on the Senate Finance Committee and the appropriate Administration officials will be most appreciated. Please advise if I or this organization may be of any assistance to you in any manner.

Sincerely,

ROGER J. BARRETO, *Chairman.*

STATEMENT OF DELOITTE HASKINS & SELLS

Deloitte Haskins & Sells is an international public accounting firm with over 330 offices in 70 countries. We provide auditing, accounting, tax and management advisory services to a broad range of individual, business and government clients. These comments are not made on behalf of any specific client, or group of clients, but rather represent our views on five items contained in the Administration's tax proposals released by the Department of the Treasury on February 26, 1982.

We appreciate the opportunity to bring these views before the Committee.

The five items on which we offer comments are: The Completed Contract Method of Accounting; The Alternative Corporate Minimum Tax; Corporate Tax Payment Acceleration; Withholding on Dividends and Interest; and IRS Enforcement Staffing.

COMPLETED CONTRACT METHOD OF ACCOUNTING

We believe that the Administration's proposal to repeal the completed contract and accrual method of accounting for taxpayers with long-term contracts should not be adopted by the Congress. The completed contract method of accounting is often the only method of accounting for long-term contracts that provides a clear reflection of income for tax purposes in those situations where the contract involves a high degree of risk. In other situations the accrual method of accounting clearly reflects income. We must take umbrage with the Administration's contention that the new progress payment method of accounting will provide a better reflection of income than the completed contract method or the accrual method. In our judgment the progress payment method will distort income heavily in favor of the government and as a consequence create tax liabilities for companies without profits.

We share the Administration's view that the percentage of completion method of accounting can best reflect a long-term contractor's income. However, as conceded by the Administration the method has proven to cause severe administrative problems because it requires the taxpayer to estimate the portion of the contract performed and project costs to complete it. As a general rule our tax system abhors the use of estimates and as a practical matter the percentage of completion method is not a realistic alternative for many taxpayers. These problems are not new and as a consequence the completed contract method of accounting was formally brought into our tax system 64 years ago. It allows taxpayers to accurately report income or loss from a contract at the time the contract is completed and all the uncertainties of performance have passed. It avoids the necessity of using estimates and accurately matches contract costs against contract revenues. While it is true that the method allows income to be deferred and therefore postpones the payment of tax, it also defers the recognition of loss until the contract is complete.

Another acceptable alternative has been the accrual method of accounting that defers costs and income recognition until the items are shipped or accepted. This method provides the standards under which taxpayers who regularly produce inventoriable items account for their income and cost of sales.

The alternative proposed by the Administration to these long standing methods of accounting is the progress payment method of accounting. The progress payment method can best be described as inconsistent. First, it is inconsistent within itself because it puts taxpayers on the cash basis for recognizing income while it requires costs to be deferred until income is recognized. Second, it is inconsistent with our income tax system which requires realization of income before a tax is levied. Illustrative of this second point is the feature of the progress payment method that requires loan proceeds secured by a contract to be treated as income.

In summary, the Treasury has admitted the impracticality of the progress payment method but has not provided an acceptable alternative with which to replace the completed contract or accrual methods of accounting.

A second part of the Administration's long-term contract proposal would require certain period costs, heretofore deducted currently, to be deferred as costs associated with a contract. Examples of these costs include interest and general and administrative expenses. In addition to being historically deducted under the completed contract method of accounting, the costs at issue are also deductible by taxpayers who use the mandatory full absorption costing rules for inventory accounting. Therefore, the adoption of the Administration's proposal will create inconsistent treatment between taxpayers who produce items, and stock them for sale, and those who produce unique items under contract.

Without exception, the nature of the costs at issue suggests that they benefit the operation of the business as a whole or are specific statutory incentives which only reach their desired potential if deducted currently. General and administrative expense is an example of a cost that benefits the operations of a business as a whole and the accelerated cost recovery allowance in excess of straight-line depreciation is an example of a provision that provides an incentive to invest which is muted if the deduction is deferred. We believe that the current costing rules for long-term contracts should be retained.

ALTERNATIVE CORPORATE MINIMUM TAX

Congress has enacted a number of tax incentives to encourage economic behavior. By enacting a minimum tax it would be discouraging much of the behavior sought by the incentives. This would be especially true with regard to those businesses that specialize in the favored activities. They would be put at a competitive disadvantage in comparison to taxpayers with higher marginal tax rates, who do not specialize in the encouraged activities. Such a system promotes inefficiencies and penalizes those businesses that have responded to economic needs determined by the Congress. For example, the preference on interest paid to purchase or carry tax-exempt securities will fall heavily on banks, increasing the overall tax burden on the industry by 50–60 percent. Banks as "financial intermediaries" have traditionally responded to tax incentives and have shared the tax benefits in lower prices for particular financing. If a new tax is associated with the municipal market you can expect a further depressed municipal bond market and higher costs of borrowing for state and local governments. This would occur coincident with more of the government financial burden being placed on state and local governments.

Although we conceptually disagree with a minimum tax on corporations, our greatest concern is that its major effect would have nothing to do with the the proposed list of so-called tax preferences targeted by the Administration. This "hidden effect" is caused by the proposed treatment of the investment credit and net operating loss carryovers. Under the proposal, corporations would be required to pay the greater of their regular income tax or an alternative tax equal to 15 percent of their alternative tax base in excess of $50,000. This alternative tax base would consist of regular taxable income, before the net operating loss deduction, plus certain tax preferences. No tax credits other than the foreign tax credit would be allowed against the alternative tax. The excess of the alternative tax over the regular tax would be carried over as a credit against the regular tax.

Not allowing the net operating loss deduction for purposes of the minimum tax would result in companies being subject to the minimum tax even though over a period of years they have had no economic profits and owe no regular tax. Although the minimum tax is carried over and can be used to offset the regular tax once the company continues to be profitable and has used its net operating loss deductions, we see no reason why a business coming from a period of unprofitable years should be required to prepay its regular tax.

Prior to 1979 the investment tax credit was limited to the first $25,000 of tax liability and 50 percent of tax liability in excess of $25,000. In 1978 Congress found this to be an impediment to investment and decided to increase the 50 percent limitation by 10 percent per year until it reached 90 prcent in 1982 and thereafter. The unavailability of the investment credit for purposes of the minimum tax reduces this limitation to 67.4 percent. (Since a taxpayer's tax liability before investment credit could be reduced from 46-percent to 15-percent, the investment credit benefit is limited to 31 percentage points therefore 31/46ths or 67.4 percent of the tax is offset by the credit.) This is below the 1980 limitation.

The net operating loss and investment credit rules account for an estimated 60–70 percent of the increased taxes generated from the proposed minimum tax, even though they are not directly treated as tax preferences. This significant change in tax policy as it relates to net operating loss and investment credit utilization will have a significant negative effect on investment decisions and is contrary to the policies adopted through the Economic Recovery Tax Act of 1981. Under the Accelerated Cost Recovery System (ACRS), depreciation deductions are accelerated to provide an investment incentive. These deductions produce lower taxable income or even losses and a resulting lower limitation on the investment credit.

Safe-harbor leasing was made part of ACRS to allow businesses with excess deductions or credits to obtain the benefits of ACRS. The minimum tax proposal applies pressure in the opposite direction by making investment tax credits and net operating losses less valuable. By doing so, it makes leasing more important to any business with low taxable income or a loss. While we believe that the safe-harbor leasing rules are necessary to allow all companies to share in the benefits of ACRS, we do not believe that added pressure should be put on their use by imposition of a minimum tax. Nor do we believe that the incentives of the Economic Recovery Tax Act of 1981 should be altered by the imposition of a minimum tax with its concomitant effects on investment credits and net operating losses.

CORPORATE TAX PAYMENT ACCELERATION

The Administration's Proposal to increase required estimated tax payments from 80 percent to 90 percent of the current year's liability is based on the faulty assump-

tion that corporations have the ability to estimate their income on a monthly basis. As professional accountants we find that the large majority of corporations do not have the ability to estimate taxable income on a monthly basis. To design and implement accounting systems to perform such a task would require a significant cost to business. While the revenue gain from the proposal is transitory the cost to business will continue in perpetuity.

There are also a number of situations in which the best accounting systems cannot provide the needed information because events or transactions that must be taken into account have not occurred. The current law (not being changed by the proposal) requires corporations to make their final estimated tax payment on the 15th day of the last month of the tax year. It will be necessary under the proposal to project the events of the final half-month to properly pay the estimated tax. Although some of these projections can be achieved with sophisticated financial and management reporting systems, for many businesses they are prohibitively expensive and even with their use some transactions will remain unpredictable.

When an underpayment occurs the current 20 percent penalty is extreme. Because the penalty is non-deductible it equates to a 37 percent cost of borrowing for a corporation with a 46 percent marginal tax rate.

Balancing the facts that (1) corporations can not precisely estimate their tax liabilities and (2) there is a government cost to deferred tax payments, it would seem equitable to assess a reasonable interest charge for any underpayment of estimated taxes much the same way interest is charged when a taxpayer is required to pay additional tax because of an audit or the filing of an amended return.

WITHHOLDING ON DIVIDENDS AND INTEREST AND IRS ENFORCEMENT STAFFING

We comment on these two proposals together because in our view they are related. We believe that our tax system should work in a fashion that all taxpayers pay the amount of tax required by law and that increased enforcement activities are appropriate to assess and collect amounts of delinquent tax. However, we also believe that the collection of tax is a government function. If this responsibility is to be shifted to the private sector, as the Administration has proposed with regard to withholding of dividends and interest the burden should be upon the Administration to demonstrate not only that a problem of collecting tax exists, but also that all reasonable government resources have been used and that the burden placed on the private sector is not inordiate in relation to the benefits to be derived.

The Administration has not convinced us (1) that the only recourse for increased compliance is withholding on interest and dividends; nor (2) that the private sector cost is warranted.

We believe that additional resources should be made available to improve the current information reporting system which has already contributed to increased compliance, but in our view has not been used to its full capacity.

STATEMENT OF THE DOMESTIC PETROLEUM COUNCIL

POSITION PAPER—CORPORATE MINIMUM TAX

The Domestic Petroleum Council is a group of medium to large-sized companies primarily concerned with domestic production of oil and gas. Some members are strictly producing, some are totally integrated, and some are affiliated with companies outside the industry. The Council's member companies operated in 47 states and offshore and produce more than 560,000 net equivalent barrels of oil and gas a day. Despite its dissimilarities, the Council agrees on certain broad solutions to the current energy and tax problems.

Recently, the members of the Domestic Petroleum Council have become concerned about the Administration's proposal for enactment of an alternative Corporate Minimum Tax ("CMT"). As proposed, the CMT is a tax which will inhibit investment of all types by corporate taxpayers. Thus, we believe that this tax which inhibits capital investment will delay rather than accelerate economic recovery in the United States.

More specifically, for the oil and gas industry, enactment of the CMT as proposed will be a step back in terms of realization of the national goal for energy independence. The expenditures for intangible drilling and development costs ("IDC") for an oil company which are currently deductible for tax purposes, represent necessary investment for an oil and gas company, to renew its inventory (reserves) and to replace current production. As proposed, the CMT will roughly double the after-tax costs of successful drilling. As a taxpayer moves into a CMT position these costs will move from 54 cents on the dollar expended to a range of 98½ to 100 cents on the dollar. Paradoxically, the tax will have its most adverse effect on the most success-

ful and economically efficient companies and those which are aggressively re-investing in renewing out nation's energy reserves.

A chart is attached showing an annual IDC budget for a company which will fall in the CMT position before finishing its (relatively) lower risk development drilling program. The higher risk exploration program could reasonably be severely curtailed or even terminated because of the high after tax costs and high risks in oil and gas exploration.

Projected on an industry-wide basis, the implications of the attached chart raise serious policy questions of U.S. energy independence and national security. Clearly any tax on the expenditure of capital on energy renewal (drilling) is counterproductive to our nation's interests.

DPC members do not believe the same policy exists, however, for corporations and other taxpayers to the extent they are using the drilling expense (IDC deduction) to shelter non-oil and gas income. Hence the Council members believe a sound tax policy could include an amendment of the present minimum tax provision for corporations to add the shelter effect (excess of IDC over oil and gas income) as a preference item. This would put corporations on the same basis for minimum tax purposes as individuals and would eliminate the potential for a bias against conducting oil and gas business in the corporate form which is inherent in the CMT as presently proposed.

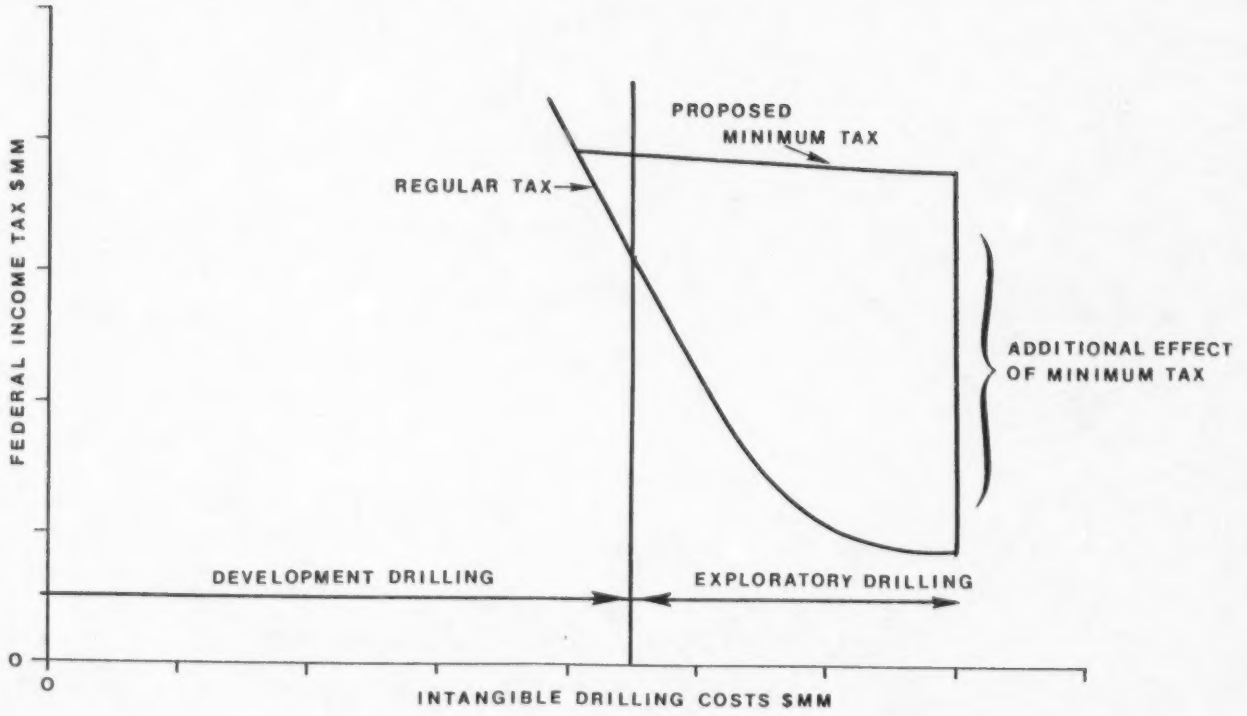
MEMBER COMPANIES

American Quasar Petroleum Company
Champlin Petroleum Company
Coquina Oil Company
Energetics, Inc.
Equity Oil Company
Hunt Oil Company
Mesa Petroleum Company
Mountain Fuel Supply Company
Pennzoil Company
Pogo Producing Company
Quaker State Oil Refining Corp.
Sabine Corporation
Santa Fe Energy Company
Sinclair Oil Corporation
Southland Royalty Company
Superior Oil Company
Tenneco Oil Company
Terra Resources, Inc.

PROPOSED MINIMUM TAX

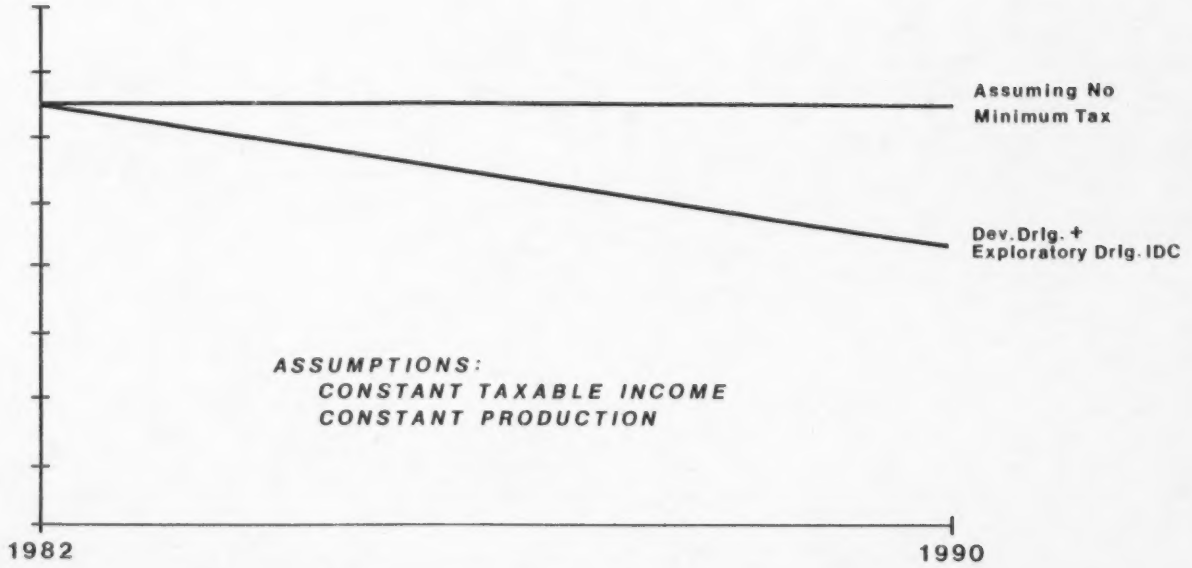
INCREASE IN FEDERAL INCOME TAX

$MM

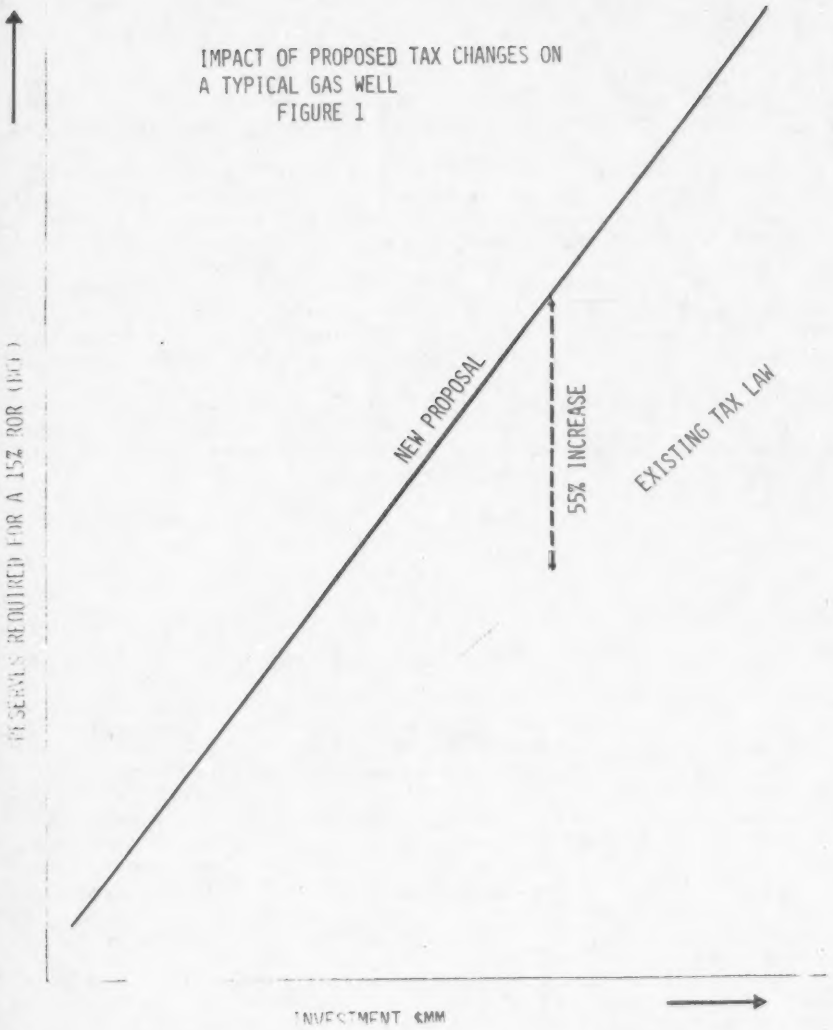


PROPOSED MINIMUM TAX

IMPACT OF PROPOSED MINIMUM TAX ON PROVED RESERVES



IMPACT OF PROPOSED TAX CHANGES ON
A TYPICAL GAS WELL
FIGURE 1



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SUPERIOR OIL CO.,
Houston, Tex., April 12, 1982.

Mr. WILLIAM GIPSON,
Pogo Producing Co.,
Houston, Tex.

DEAR BILL: At your request, the DPC tax committee met last week to examine four potential alterations to the Corporate Minimum Tax proposed by the Administration.

As an overview, the tax committee agrees that any increase in tax in substitution to the Corporate Minimum Tax should be neutral in investment decision. It should maintain present investment incentives and should be easy to administer. Finally, any substitute tax should be consistent with overriding U.S. energy and security policy.

An outline of the policy considerations for (i) an increase in motor fuel excise tax, (ii) corporate income tax surcharge, (iii) oil import fee and (iv) energy users tax are enclosed. We have also added considerations for a federal severance tax denominated by the name "Energy User Tax" which may be proposed by Senator Long this year.

The considerations outlined basically reflect those identified by the committee on public issues for the A.P.I. as reworked by tax committee. The fifth item, Senator Long's federal severance tax proposal, is included because it was our understanding that Senator Long is making this proposal as a serious one.

Very truly yours,

J. DAVID ANDERS,
Chairman, Tax Committee.

Attachment.

ISSUES PRESENTED IN POTENTIAL REVENUE RAISING ALTERNATIVES FOR 1982

1. Increase motor fuel excise tax (Generate about $1 billion per $.01/gallon increase):

a. The present motor fuels excise tax ("MFET") will be automatically cut back to 1½ cents from 4 cents effective October 1, 1984 unless the 4 cents is extended. If the cut back in projected revenues is incorporated in the current deficit, simply maintaining the current rate will produce significant additional revenues.

b. An increase in MFET should not affect capital investment decisions.

c. The MFET impacts consumers of motor fuels which provides relatively broad base. It may create a cost recovery problem for business users and may exacerbate auto industry problems. The greater the increase, the more significant the problem.

d. This increase will tend to have a uniform impact on unit costs of each competitor within each relevant market.

e. From a petroleum industry viewpoint, it is relatively uniform geographically. Impact on consumers varies geographically.

f. A tax increase could increase conservation, which is consistent with the goal of reducing motor fuel demand.

g. Although any additional tax tends to hamper economic recovery, MFET is probably least offensive economically from a standpoint of international business competition. It may increase inflation which affects indexed wages, transfer payments and interest rates. A tax on consumption is less offensive than a tax on investment which tends to reduce productivity.

h. It would likely be perceived as a tax on consumers, vis-a-vis the Corporate Minimum Tax ("CMT").

i. It would likely be permanent; it would be easy to administer.

j. To the extent the increase is placed in the General Fund, there is a shift away from the use fee concept which would dedicate these revenues solely for highway purposes.

2. Corporate income tax-surcharge (About $1 billion per one percent):

a. As a relatively profitable segment of the economy, the petroleum industry would probably pay a large portion of this type of tax. As industry profits fall the amount of tax will also fall, however.

b. Depending on the method of calculation, the impact varies substantially within the industry depending on upstream/downstream relationship, degree of exploration and development activity and extent of foreign operations.

c. It is probably neutral geographically.

d. It would probably not seriously affect energy policy.

e. It probably would not seriously hamper economic recovery, would not penalize investment, and will be easy to administer.

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f. One of the popular arguments in favor of the proposed minimum tax is that it would require all corporations to pay some tax. Although the coprorate surtax would probably allow some firms who presently pay no tax to remain in that position, and require those firms with already high tax burdens to pay the greatest amount of surcharge, it would probably be perceived as a reasonable alternative to the minimum tax.

g. It is least likely to be permanent. Surtax designation implies temporary levy and creates large constituency for termination.

3. Oil import fee on crude and product ($3.5 billion per $1 per barrel):

a. It would affect all petroleum product users and would present a cost recovery problem for business users (U.S. petrochemical, etc.).

b. Domestic crude oil prices would probably rise in parallel with imports. Those members of the petroleum industry having domestic production would derive some benefit unless Congress passed an excise tax on domestic production to "soak up" any such price increase remaining after windfall profit tax.

c. Unless an exemption mechanism was in effect, it would have a negative impact on U.S. exports of products of energy intensive industries.

d. It would encourage conservation and domestic production of crude oil and development of synthetic and other competitive fuels.

e. The impact of the fee within the petroleum industry would very greatly depending upon individual company operations. Its impact would also vary geographically. Dealing with these equities would likely require a complex tax structure.

4. Energy user tax (burner tip tax) ($4.8 billion for each one percent):

a. As a tax based on market price of most forms of energy it would be relatively broad based and would impact consumers.

b. It may increase inflation and inflationary expectations which affect indexed wages and transfer payments, interest rates, etc. A tax on consumption is less offensive than a tax on investment which in turn tends to reduce productivity.

c. It would increase cost recovery problems for business users, particularly all U.S. manufacturing vis-a-vis international competition. If applied to all energy, it would avoid creating distortions in inter-fuel competition.

d. Impact on consumers varies geographically.

e. It would likely be perceived as a tax on consumers, vis-a-vis the CMT.

f. It would probably be difficult to administer.

g. It would likely be permanent.

h. Tends to be relatively neutral among firms in petroleum industry.

5. Energy user tax—Long's proposal (revenue projections unknown):

a. Senator Long is proposing a federal severance tax on gas (35 cents/mcf), oil ($2/bbl) and coal ($7/ton); federal revenue projections are unknown.

b. As a severance tax on U.S. Production it would tend to be borne by U.S. producers to the extent prices would not rise in the market to absorb the additional costs. To the extent prices do rise, prices of imports could be expected to increase thereby passing on the increased costs to the benefit of foreign producers and the detriment of consumers.

c. This tax could serve as the "soak up" tax to balance domestic and foreign prices if there was an oil import fee, see 3(c) above.

d. The tax would not assist in capital formation in the oil industry and could hurt it.

e. There is danger the tax could be permanent.

EMERY WORLDWIDE,
Wilton, Conn., April 7, 1982.

Hon. DANIEL ROSTENKOWSKI,
Chairman, Committee on Ways and Means, House of Representatives, Washington, D.C.

DEAR REPRESENTATIVE ROSTENKOWSKI: I understand your committee is currently considering both the Revenue Title (H.R. 4800) to the Airport and Airway Development bill and the administration's fiscal year 1983 revenue proposals. The issue of air freight waybill taxes arises in connection with both of these matters.

H.R. 4800, if adopted, would impose an air freight waybill tax at 5 percent, while reducing the passenger ticket tax from 8 percent, the rate which applied when aviation taxes were last paid into the Aviation Trust Fund to 5 percent.

I urge you to follow two basic principles in considering these waybill tax proposals:

First, user taxes paid into the Aviation Trust Fund in past years should be expended for their intended purposes before new taxes are imposed.

Second, user taxes must be assessed fairly. In the context of air freight waybill taxes, this means that all segments of the aviation industry should pay a fair share

of the costs of serving their needs; that aviation users should not be required to pay for services which benefit the public at large rather than the users themselves, and that aviation users should not bear a greater tax burden of paying of government services than other industries do.

Emery Worldwide is—and long has been—the premier air freight forwarder in the nation. Its success, and the valuable service it provides to the shipping public, depends in substantial part on the airport and airways system maintained by the federal government. For that reason, Emery Worldwide believes it should pay its fair share of the cost of the system. However, Emery Worldwide believes others, including general aviation, must also pay their fair share.

Reimposition of a 5 percent air freight waybill tax at a time when passenger ticket taxes are being reduced from prior levels would seem particularly inequitable. Imposition of a 5 percent tax on air freight with passenger taxes at 8 percent would fail to reflect the relative costs of benefits to passenger and cargo services from airport and airways programs.

Expenditures under the airport and airways program primarily benefit passenger traffic and, as such, benefits to cargo traffic are a by-product of expenditures made to accommodate passenger traffic. Passenger flights are scheduled for prime daylight hours, the time when most passengers want to fly. This prime time passenger demand places the principal strain on the airport and airways system during the morning and early evening. Passenger transportation thus causes both capital expenditures which would not be required for air freight transportation and high operating costs of peak periods.

Air freight, however, is a night animal, and its prime time is in the middle of the night when there are very few passenger flights operating. The very nature of all-cargo aircraft movement requires night time operations so that parts and products can be shipped at the end of the working day and arrive at the destination airport before sunrise. Thus, air freight principally uses the airport and airways system when demand is at its lowest level and, therefore, should be priced on an added-cost basis in determining an appropriate tax.

Because the airport and airways program itself focuses primarily on the needs of passengers, funding from the program has been designed to facilitate passenger transportation and separate cargo ficilities have been self-supporting. For instance, Emery Worldwide itself has developed a major cargo hub facility that includes aircraft ramp and taxiways in Dayton, Ohio at a cost of approximately $50 million. Emery plans to expand the facility over the next several years at a total investment of approximately $150 million to the company. If air freight taxes are imposed at all, the airport and airways program should assure that expenditures directly benefiting air freight transportation are made under the program. Moreover, I believe that air freight waybill taxes should in no event exceed 20 percent of the level of taxes imposed on passenger tickets because of the relatively small governmental cost burden imposed by cargo operations and that general aviation should shoulder a fair allocation of aviation systems costs.

Finally, I am sympathetic to concerns that revenues now being collected from aviation users are going into general funds rather than the aviation trust fund. Consequently, I support legislation which would provide for payment of existing taxes into the aviation trust fund. I cannot, however, support an interim measure which would put air freight waybill taxes on a par with passenger ticket taxes for the reasons expressed above. Consequently, I would urge adoption of legislation which would simply provide for allocation of existing taxes into the trust fund while the longer-range issues of fair taxation for aviation users are being resolved.

Sincerely yours,

JOHN C. EMERY, Jr.

STATEMENT OF MICHAEL D. BROMBERG, EXECUTIVE DIRECTOR, FEDERATION OF AMERICAN HOSPITALS

HEALTH FACILITIES FINANCED WITH SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS

Mr. Chairman, the Federation of American Hospitals appreciates this opportunity to present our views to the Committee on small issue industrial development bonds (IDBs) and the financing of hospitals and other health care facilities.

The Federation of American Hospitals is the trade association for the approximately 1000 investor-owned hospitals and hospital management companies. Very few of these investor-owned hospitals were built with IDC financing due to the fact that a $10 million ceiling applies to projects involving small issues used in connection with for-profit health institutions. Those few hospital projects which have used

small issue bonds financing involve small hospitals or expansions in rural communities.

The Administration's proposal to curb the use of tax-exempt bond financing in general, and small issue IDBs in particular, have focused attention on users such as nightclubs, fast food establishments, and retail or commercial operations which some felt were not contemplated by Congress. Little attention has been focused on the contribution of this form of financing to health services in economically marginal areas of the country where other forms of financing are not available.

Only about one percent of tax exempt financing for hospitals involves small issue IDBs for investor-owned hospitals. Over the past decade we estimate that fewer than fifty investor-owned hospitals have been built with IDBs but these facilities are located in areas of clear need and many represent sole community providers.

Without IDB financing, such communities would often have no choice but to take on the burden of providing needed health care services directly through a community owned and operated facility financed by public or not-for-profit authorities. Because of the increased complexity and escalating cost of hospital operations, however, communities have been withdrawing from such direct service delivery commitments and turning increasingly to investor-owned systems which have the managerial capacity and operational efficiencies to maintain and improve health care quality.

The need for all types of health care capital financing will be even greater over the next decade. Conservative estimates place capital needs in the 1980s at $190 billion for essential hospital replacement alone. In addition, this country has a major existing shortfall in nursing home beds which will increase substantially as the number of elderly as a percentage of the population increases. An estimated $10.6 billion in capital will be necessary to construct the 260,000 long term care beds needed by 1990. Small issue IDB financing will be a critical function in many communities caring for their elderly.

Having described the importance of small issue IDB financing is not to suggest that reforms in the program are not necessary. It is clear that abuses have occurred and must be prevented from re-occurring in the future. Restricting access to IDBs for enterprises which are not clearly in the public interest such as nightclubs are certainly justified. Requiring public hearings and reporting of information on IDB use are also in the public interest. We believe that these and other improvements in the program can be made without having to resort to eliminating the program where it has demonstrated its value to communities throughtout this country.

The Administration's proposal to eliminate big business use of IDBs is arguably irrelevant and discriminatory in this context. If the IDB serve a valid public purpose, then the size of the company should not be consequential.

Finally, it is important and relevant to vote the impact on the Medicare budget of any move to eliminate health facility IDB financing. If small issue financing is unavailable and if commercial financing is utilized, debt service costs will increase substantially in those health facilities. Health care costs will rise in general and Medicare cost reimbursement for higher interest payments will increase Medicare trust fund expenditures in particular.

Sound public policy for providing access to health facilities in rural and economically depressed areas and sound federal budget policy for containing Medicare expenditures lead us to conclude that health facilities should be exempt from the proposed elimination or restrictions on small issue IDBs.

FISCHBACH & MOORE ELECTRICAL CONTRACTING, INC.
Chicago, Ill., April 7, 1982.

Mr. DAN ROSTENKOWSKI,
Chairman, House Ways and Means Committee,
Washington, D.C.

DEAR MR. ROSTENKOWSKI: We refer to the pending regulation and legislative changes to the completed contract method of accounting for federal income tax purposes.

Fischbach Corporation is the largest electrical subcontractor in the United States, as well as the largest mechanical subcontractor. The company (and its subsidiaries, of which we are one) has approximately 14,000 employees working out of 100 local offices. Fischbach Corporation's backlog of construction work is $1.9 billion, and represents approximately 3,000 contracts in progress. The company is publicly owned and its stock is listed on the New York Stock Exchange. All its reports to the public are now and have always been prepared on the completed contract method of accounting. To the best of our knowledge, the company has filed its tax returns on the completed contract basis each year since its founding in 1924.

After carefully considering the proposed changes, we strongly oppose the elimination of completed contract accounting for the following reasons:

1. Such change will seriously affect the cash flow of most construction subcontractors. The industry works on an after tax margin of approximately 2 percent. Obviously, additional costs resulting from the proposed changes will be passed on to the user. It is not realistic to expect contractors operating at such low margins to absorb these costs; their only alternative to increasing prices will be to cease doing business.

2. Based on Fischbach's experience in having completed tens of thousands of jobs, we believe that the profitability of a job cannot be determined before substantial completion, nor in many instances, before the job has been completely closed and accepted by the customer.

3. The proposed legislation can result in our having significant and long term income tax investments in jobs that eventually lose money. These investments (a) cost us money, further reducing our competitiveness, (b) would appear to be unfair, and (c) inconsistent with tax treatment of other industries. Assume the following three-year job which closed in 1983;

TOTAL CONTRACT VALUE, $30,000

	1981	1982	1983	Total accumulated
Income	10,000	12,000	8,000	30,000
Costs	8,000	14,000	10,000	32,000
Excess of income over costs (costs over income)	2,000	(2,000)	(2,000)	(2,000)
Taxable income (loss)	2,000	0	(4,000)	(2,000)
Tax payable (50 percent) (recovery)	1,000	0	(2,000)	(1,000)

The investment in income taxes made in 1981 on a project eventually showing a loss would not be recoverable for two years.

4. Indirect costs should continue to receive the same treatment they presently do under existing regulations. The administrative burden to the company in allocating costs to 3,000 contracts in progress would be expensive and unreasonable. More importantly, the audit difficulties this would create will give rise to continuing disputes between contractors and the IRS. Allocation of indirect costs would generate a short-term improvement in the Treasury's cash flow, but on a longer term basis it will have no positive effect.

Our industry overhead costs are similar in nature to general and administrative costs incurred by manufacturing, retailing, wholesaling, etc., organizations. For tax and accounting purposes, these organizations do not generally consider such costs as part of their inventory (inventories of these organizations are counterpart to a contractors work in process) and accordingly, if contractors were forced to capitalize general and administrative costs, it would be inconsistent with the treatment allowed to other businessess.

It is also proposed that interest paid no longer be treated as a cost deductible in the year in which it was paid. Rather it is proposed to include such costs in work in process:

A. This again will result in a significant additional tax burden to our industry with the consequent effects outlined previously.

B. The inclusion of interest in work in progress would, from a taxation point of view, place the contracting business at a disadvantage to and be inconsistent with tax treatment allowed other industries.

C. Not all interest expense relates to operations. It may relate to acquisitions of other companies, non-job-related assets or expenses, e.g. head office buildings, advertising campaigns, etc. To allocate such costs to jobs would at best be an arbitrary time consuming and largely inaccurate procedure, and would also result in IRS audit difficulties.

4. Because of the profit uncertainty, the calculation of earnings by the percentage of completion method is a subjective process, not readily ascertainable by even the most careful accountants, and results in continuing difference of opinion, dispute and litigation between the IRS and a taxpayer using the percentage of completion method, since any such calculation must be based on analysis of what the future may hold for the particular job.

The tax law, as it applies to construction contractors, should not be based in the uncertainties of estimating costs to complete for jobs in progress. it may be assumed that taxpayers will be overly conservative in using this method of accounting for tax purposes.

The tax code is replete with income deferring devices, e.g. intangible drilling and development costs, accelerated depreciation, installment sales method. It is discriminating to single out one segment of industry and disturb a long established approach to taxation in order to create short-term cash flow benefit for the Treasury.

6. The proposed progress payment method is inequitable. While legislation provides for the excess of billings over cost on any job in progress to be included in taxable income, it does not under normal circumstances appear to provide for the deduction from taxable income of the excess costs over billing situations which are common occurrences:

(A) They are often related to such matters as material buyouts, and costs associated with items yet to be approved by customers and not yet billed.

(B) Also, many projects are low profit margin jobs, and it is only at the time that our retention is billed (i.e. at the end of a job) that our billings finally exceed costs.

The fact that there is no provision for tax relief in the legislation for situations such as (A) and (B) above would seem unfair. We will continue to be faced with financing charges relating to these situations in addition to those necessary to pay interest on funds borrowed to pay the increased income taxes outlined above.

7. With reference to the progress payment method of accounting it appears that an assumption is being made that the "right to receive" is easily defined by the terms of each contract. In reality this is not the case. Monthly progress payments are subject to negotiation and adjustment. The subcontractor does not know what the "right to receive" is until the general contractor has processed the payment request and forwarded the check—which is often 30 to 60 days following the billing. Obviously, subcontractors bill for the maximum they feel they have a right to receive. On the other hand, the general contractor and owner will attempt to pay a lesser amount. Given this situation, it will be difficult to determine, and audit, the "right to receive" at the end of the tax year.

8. It may be assumed that financial statements issued by taxpayers for public purposes only, using the percentage of completion method, are prepared with a good deal of optimism in order to present the best picture for purposes of bonding, credit, etc. When used for tax purposes, it should be expected that proper reserves would then be introduced to provide for such contingencies as back charges, claims by the owner or general contractor, non-reimbursable completion costs, together with other reserves or deductions, perhaps proper, perhaps disputable. Such deductions would not be made and would not become the subject of a tax dispute if the return has been prepared on the completed contract method.

9. Because of the negative effects on earnings, we also believe that the proposed legislation will have an adverse effect on the construction industry's ability to raise new funds from the investing public. Because of the nature of our business, it has not been one that has traditionally attracted investor confidence. Earnings multiples on construction industry stocks have often been on the low end of the scale—irrespective of general stock market conditions. This proposed legislation may do further damage to our collective positions by weakening future earnings prospects.

We urge the continuance of an unrestricted right by long-term construction contractors to elect the completed contract method of reporting income tax for all long-term contracts. To do otherwise would substitute an uncertain litigious method for the clear and comparatively simple completed contract method; would interfere with the ability of surety companies, financial institutions and creditors to determine the financial status of the contractor by removing the only clear and positive form of financial statement; would not increase overall revenue to the government from the construction industry; and to the extent that additional borrowings for taxes would be required of many contractors, with corresponding reduction of taxes by other more conservative taxpayrs, would be inflationary.

The writer would like the opportunity to present his viewpoints at any formal regulatory or legislative hearings.

Very truly yours,

W. P. GUTEKANST, *President.*

[NOTE: Letters identical to the above were received from the following:

THE BALDWIN-STEWART ELECTRIC CO., Farmington, Conn., Robert N. Lieder, *President*

BEACH ELECTRIC CO., East Orange, N.J., William Travis, *Chairman of the Board*

BUFFALO ELECTRIC CONSTRUCTION CO., INC., West Seneca, N.Y., A. A. Caldwell, *Executive Vice President*

THE W. W. CLARK CORP., Cleveland, Ohio, H. L. Anderson *President*
DEEVERS ELECTRIC CO., Davenport, Iowa, W. P. Gutekanst, *President*
FISCHBACH & MOORE, INC., Dallas, Tex., A. B. Adley, *Executive Vice President, Finance and Administration*
FISCHBACH CORP., New York, N.Y., Edwin A. Wilinski, *Executive Vice President*
FISCHBACH & MOORE OF ALASKA, INC., Anchorage, Alaska, Ken J. Sutherland, *President*
T. H. GREEN ELECTRIC CO., INC., Rochester, N.Y., Carl R. Swetman *President*
JOHN MILLER ELECTRIC CO., INC., Troy, Mich., T. A. Weedmark, *President*
POWER SYSTEMS, INC., Schaumburg, Ill., William L. Foster, *Chairman of the Board;* George E. Gandsey, *President*
A. S. SCHULMAN ELECTRIC CO., Chicago, Ill., W. P. Gutekanst, *President*
WATSON-FLAGG ELECTRIC CO., INC., Indianapolis, Ind., Joseph Accardi, *President*]

FISK ELECTRIC CO.,
Houston, Tex., April 21, 1982.

Hon. DAN ROSTENKOWSKI,
Chairman, House Ways and Means Committee,
Washington, D.C.

DEAR MR. ROSTENKOWSKI: Regarding the proposed changes to the federal icome tax regulations relating to the completed contract method of accounting for the construction industry, it is our opinion that this piece of legislation, if passed, would be detrimental to not only the industry, but also to the overall economy.

Fisk Electric Company, which was founded in 1913, is one of the ten largest electrical contractors in the United States (as ranked by Engineering News Record), with sales approximating $93,000,00 for the last two years, and an average employment of 1,400 people. It has been the Company's policy to report for federal income tax purposes on the completed contract basis.

Our reasoning for supporting the continued use of the completed contract method is as follows:

(1) The percentage of completion method or progress billing method only accelerates collection of taxes and does not create any new sources of revenues for the federal government.

(2) This increase in collection will put the majority of contractors in a severe cash flow bind, which will require additional debt financing. We feel that this will have two adverse effects:

(a) increased pressures on the country's monetary system,

(b) additional interest expenses, which would reduce the income tax payable by many contractors.

(3) The completed contract method of accounting assures that the correct amount of tax is paid when the exact amount of profit is determined. It has been our experience that, during the course of most major projects, profit and/or loss projections are revised numerous times and the final profit/loss is not known until all billings are collected and all costs are incurred. Our Company believes that the burden placed upon the Internal Revenue Service in reviewing these cases would create a cost to the federal government which would far outweigh the expected benefits.

(4) Finally, in many of our contracts, the retention held by the general contractor/owner equals or exceeds our profit on a project. Therefore, if the completed contract method of accounting were eliminated, in most instances we would be forced to pay taxes on profits which we have not yet received.

In concluding, we would like to point out that most contractors earn (on an after-tax basis) two to three percent on gross revenue. Therefore, we feel that if the proposed regulations are enacted, an unnecessary burden would be placed on the contractors of the United States at a time when the survival of many firms is being threatened by the current economic recession.

We will be happy to discuss our position further on either an informal basis or at a formal legislative or regulatory proceeding.

Very truly yours,

J. CHRIS JONES, *Corporate Auditor.*

GEORGIA RESIDENTIAL FINANCE AUTHORITY,
Atlanta, Ga., April 14, 1982.

Re The Administration's Revenue Proposals.
Mr. JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means,
U.S. House of Representatives, Washington, D.C.

DEAR MR. SALMON: I am writing to express this Authority's opposition to certain provisions of the President's revenue proposals. We particularly object to the inclusion of multifamily rental housing in the Administration's changes in Industrial Development Bond legislation.

We understand the Administration's reasoning behind its desire to curb the growth of small issue IDBs; however, we think this reasoning is not applicable to rental housing bonds because market forces reflecting rental housing development needs coupled with cutbacks in federal production assistance programs will serve that purpose. More specifically, requiring an in-kind contribution (which is unlawful in Georgia) discriminates against less affluent states which probably are in the greatest need of low and moderate income rental housing.

Furthermore, the arbitrage and reserve fund sections of the proposal would eliminate our ability to establish the cash reserves necessary to ensure the long-term viability of rental projects. The prohibition against rental housing investment syndicates would eliminate non-profit groups from raising capital for housing services and provide lower rents.

We are convinced that the need for rental housing in Georgia and throughout the nation will increase dramatically in this decade. This need will be greatly influenced by the high cost of single family homes and the conversion of rental units to condominiums. If our low income citizens are to have access to safe, decent and sanitary rental housing, then there must be some increase in rental housing production. A debacle similar to the Mortgage Subsidy Bond Tax Act (the Ullman Bill) impact on single family homeownership should not be inflected upon rental housing.

Consequently, we strongly urge the members of the Committee on Ways and Means to strike any reference to rental housing from the President's IDB legislation.

Sincerely,

HENRY M. HUCKABY,
Executive Director.

STATEMENT OF HAWKINS, DELAFIELD & WOOD, NEW YORK, N.Y.

This statement is submitted in accordance with Press Release No. 22 with regard to the hearings which began on March 29, 1982 on the Administration's revenue proposals. Specifically, this statement is directed to any consideration that the Committee may give to a maximum tax on income, including state and municipal bond interest. The principal points presented in the statement are summarized as follows:

A minumum tax on income including state and municipal bond interest, if enacted into law, would be unconstitutional. The decision by the Supreme Court of the United States in the *Pollock* case holds that a tax on the interest from state and municipal bonds is unconstitutional. The Sixteenth Amendment did not change the decision in the *Pollock* case. The history of the adoption of the Sixteenth Amendment confirms the Congressional and Supreme Court construction of its intent and meaning. To the extent that a minimum tax applies to interest on local housing authority obligations it also impairs the obligation of contract.

I. A MINIMUM TAX ON INCOME INCLUDING INTEREST ON STATE AND MUNICIPAL OBLIGATIONS WOULD BE UNCONSTITUTIONAL

A minumum tax would include in the gross income a taxpayer the amount of so-called "disallowed tax preferences" and would define the so-called "items of tax preference." Among such items might be any excess of interest on obligations which is currently excludable from gross income under section 103 of the Internal Revenue Code of 1954, as amended, namely the interest on "the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia".

The Senate Committee on Finance considered such a minimum tax under the Tax Reform Act of 1969 (H.R. 13279). The bill as proposed included a section which would have limited tax preferences to (1) one-half of the sum of the items of tax preference and the taxpayer's adjusted gross income or (2) $10,000, whichever is greater. Hawkins, Delafield & Wood submitted a statement to the Committee on Fi-

nance while that proposal was under consideration by such Committee. The statement as it related to the minimum tax proposals presented the same analysis that is contained herein. The proposal for a minimum tax on income which includes interest on state and municipal obligations was not included in the bill reported out of such Committee. Senate Reports No. 91-552, Tax Reform Act of 1969, at 2023. Reconsideration of a minimum tax by the Committee on Ways and Means should lead to the same result now as it did in 1969. If such a tax is proposed and includes income on state and municipal obligations, it would be unconstitutional.

Law, as Mr. Justice Holmes has told us, is a "prophecy of what courts do in fact." In our opinion, the Supreme Court would hold that such a tax on the interest on state and municipal obligations is unconstitutional for the reasons stated below. From the time the income tax was imposed in 1913 until now both Congress and the Supreme Court have adhered steadfastly to the constitutional doctrine that state and municipal bond interest is exempt from federal income tax. It would be strange for Congress to abdicate its obligation to respect constitutional limitations upon its power by levying a tax on such interest without new constitutional authorization.

The doctrine of federal immunity from state interference, including interference by taxation, is a general principle of constitutional law with which this Committee is undoubtedly familiar. The converse immunity of the states from federal interference is equally well established. In *National League of Cities* v. *Usery*, 426 U.S. 833 842 (1976), the Supreme Court stated unequivocally that the constitutional doctrine of intergovernmental immunity imposes "limits upon the power of Congress to override state sovereignty, even when exercising its otherwise plenary powers to tax or to regulate commerce which are conferred by Art. I of the Constitution." The doctrine was specifically applied to interest on obligations of states and municipalities and of state and municipal instrumentalities by the Supreme Court of the United States in the landmark case of *Pollock* v. *Farmers' Loan & Trust Company*, 157 U.S. 429 (1895) and on rehearing, 158 U.S. 601 (1895).

The case decided by the Supreme Court under the Sixteenth Amendment as well as the legislative history of the amendment in Congress during ratification by the state legislatures demonstrate that any claim that the amendment repudiated the rule of the *Pollock* case is unsupported by any judicial precedent, is unfounded in fact, and altogether spurious.

For the purpose of this statement it is not necessary or desirable to delve into the much repeated history of the constitutional doctrine of reciprocal immunity before August 15, 1894 when Congress enacted a statute which levied a tax upon net income, including the interest on state and municipal bonds.

At that time and until the Sixteenth Amendment became effective on February 25, 1913, Article I, Section 2, of the federal Constitution required the apportionment of "direct taxes" among the states according to population, as follows: "Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective numbers, which shall be determined by adding to the whole Number of free Persons, including those bound for Service for a Term of Years, and excluding Indians not taxed, three-fifths of all other Persons."

Article I, Section 8, of the Constitution also required that "Duties, Imposts and Excises" shall be uniform, as follows: "The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defense and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States, . . ."

A. The Pollock case holds that a tax on the interest from state and municipal bonds is unconstitutional

In the *Pollock* decision which considered the validity of the income tax law of 1984, the Supreme Court, pointed out that the federal government had an unlimited power of taxation with a single exception and subject to two qualifications. The one exception was that "Congress cannot tax exports . . . " The two qualifications were that Congress "must impose direct taxes by the rule of apportionment, and indirect taxes by the rule of uniformity." 157 U.S. at 557.

In the first *Pollock* case the Supreme Court held that a tax on the rents and other income from real estate was a direct tax and consequently violated the Constitution because the tax was not "apportioned among the several States . . . according to their respective numbers." The Court also unanimously held that the taxing power, like any and all other power of the federal government, was impliedly subject to the constitutional limitation that it could not be so exercised that the instrumentalities of the states were taxed. 157 U.S. at 584.

Thus, the first decision in the *Pollock* case held the income tax act of 1984 invalid in respect of (1) the tax on rents and other income from real estate and (2) the tax on the interest from state and municipal bonds. The justices divided equally on the constitutionality of the income tax pertaining to personal property other than state and municipal obligations and on whether the 1984 act as a whole was unconstitutional.

On rehearing the Supreme Court decided (four of the justices dissenting) first, that the tax on income from personal property was a direct tax and hence was invalid because not apportioned and, second, that the 1984 Act was unconstitutional in its entirety.

The *Pollock* decision was unanimous as to municipal bond interest because in the words of Mr. Justice Fuller, to tax the interest on municipal bonds "would operate on the power to borrow before it is exercised, and would have a sensible influence on the contract," and would be a "tax on the power of the States and their instrumentalities to borrow money and consequently repugnant to the Constitution." 157 U.S. at 586.

To the same effect was the separate opinion of Mr. Justice Field: "These bonds and securities are as important to the performance of the duties of the State as like bonds and securities of the United States as the former are exempt from the taxation of the States." 157 U.S. at 601

And Mr. Justice Brown who had concluded that "a tax upon rents or income of real estate is a tax upon the land itself" nevertheless said in the second *Pollcok* decision: "That tax upon the income of municipal bonds falls obviously within the other category, of an indirect tax upon something which Congress has no right to tax at all, and hence is invalid. Here is a question, not of the method of taxation, but of the power to subject the property to taxation in any form." 158 U.S. 692-693

Thus, all the justices in both *Pollock* decisions, whether they subscribed to the theory that a tax on income was a tax on the source of the income or considered that theory untenable, came to the identical conclusion that the interest on state and municipal obligations could not be included in federally taxable income. It is clear, therefore, that the decision in *Polock* concerning the unconstitutionality of taxing state and municipal bond interest rests not on the economic premise that a tax on income is a tax on the source of the income but on the invioability of the borrowing power of the states and their political subdivisions.[1]

B. The Sixteenth Amendment did not change the decision in the Pollock Case.

This, then, was the law when the Sixteenth Amendment was declared in full force and effect by the Secretary of State on February 25, 1913. The Amendment reads: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

1. The Congress has construed the Sixteenth Amendment consistently with the decision in the Pollack Case.—Even before the Supreme Court decided that the phrase "from whatever source" in the Amendment relates not to the power to tax but to the requirement that certain federal taxes must be apportioned among the states according to their respective populations, Congress had also concluded that the object of the Amendment was to eliminate the necessity of *apportionment* irrespective of source in order that the income derived from the source of real and personal property could be taxed. Briefly stated, the Amendment means that a tax on income "from whatever source" is immune from the constitutional requirements of apportionment. 38 Stat. L. 168 (1913); 39 Stat. L. 758-59 (1916); 40 Stat. L. 329-30 (1917) and 1065-66 (1918).

When a revenue act was drafted during World War I with a provision to include the interest on municipal bonds in gross income, the lack of power to tax such interest was expressed both in committee reports and congressional debate. It was recognized that lack of apportionment was not the objection to federal taxation of state and municipal bond interest but that the lack of power to tax such interest was absolute. The provision was omitted. H. Rep. No. 767, (65th Cong. 2nd Sess.) p. 9; Sen. R. No. 617, (65th Cong. 3rd Sess.) p. 6; 56 Cong. Rec. p. 9; Sen. R. No. 617, (65th Cong. 3rd Sess.) p. 6; 56 Cong. Rec. p. 10933-41, 10628-33, 11181-86.

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[1] The reluctance of the four justices in both *Pollock* cases to accept the theory that a tax on income is a tax on the source of the income was later shared by the Supreme Court in *New York ex rel Cohn* v. *Graves*, 300 U.S. 308 (1937) in which the New York State income tax on rents from real estate in new Jersey was upheld. Obviously, however, this was not the *ratio decidendi* of the *Pollock* case, because four of the justices who did not agree that a tax on income from personal property was a tax on the property itself joined with the other justices in invalidating the tax on municipal bond interest.

Such a contemporaneous construction of the Sixteenth Amendment by Congress from the time it became effective through World War I is certainly an influential if not a controlling consideration in determining the meaning of the Amendment.

Later, in 1923, after the decision of the Supreme Court in *Evans* v. *Gore*, 253 U.S. 245 (1920), to be discussed below, Congress considered and the House of Representatives passed a constitutional amendment[2] to authorize the taxation of income derived from future issues of state and municipal bonds and to authorize states to tax the income of future issues of federal bonds. H.J. Res. 314, (67th Cong. 4th Sess.); H. Rep. No. 969, (67th Cong. 2d Sess.) The proposal failed to pass the Senate.

2. The Supreme Court has construed the Sixteenth Amendment consistently with the decision in the Pollack Case.—In *Evans* v. *Gore*, 253, U.S. 245 (1920), the Supreme Court held (Justice Holmes and Brandeis dissenting) that the Sixteenth Amendment did not authorize an income tax on the salary of a federal judge in view of the fact that the Constitution provided that the compensation of judges "shall not be diminished during their continuance in office." Const. Art. III Sec. 1.

The Court then considered whether the constitutional inhibition against such diminution was modified by the Sixteenth Amendment. After an elaborate analysis of the Sixteenth Amendment the Court concluded that: "the genesis and words of the Amendment unite in showing that it does not extend the taxing power to new or excepted subjects, but merely removes all occasion otherwise existing for an apportionment among the States of taxes laid on income, whether derived from one source or another." 253 U.S. at 261-2.

Although *Evans* v. *Gore* was overruled in *O'Malley* v. *Woodrough*, 307 U.S. 277 (1939), it is clear from the opinion of Mr. Justice Frankfurter in the latter case that the decision that federal judges could be taxed on their salaries was based on the premise that, as Justices Holmes and Brandeis had said in their dissenting opinion in *Evans* v. *Gore*, a tax on salaries was not a diminution of compensation. Only that portion of the majority opinion in *Evans* v. *Gore* was repudiated and not one word in the opinion in *O'Malley* v. *Woodrough* questions the above-quoted conclusion of the Court in *Evans* v. *Gore* concerning the Sixteenth Amendment.

In *Evans* v. *Gore* the Supreme Court had referred to previous cases in which the Court had considered the Sixteenth Amendment, beginning with the opinion of Chief Justice White in *Brushaber* v. *Union Pacific R.R. Co.*, 240 U.S. 1 (1916) which was the first case involving the scope and meaning of the Sixteenth Amendment. In that case, referring to the text of the Amendment the Chief Justice had declared (240 U.S. at 17-18): ". . . It is clear on the face of this text that is does not purport to confer power to levy income taxes in a generic sense—an authority already possessed and never questioned—or to limit and distinguish between one kind of income taxes and another, but that the whole purpose of the Amendment was to relieve all income taxes when imposed from apportionment from a consideration of the source whence the income was derived. Indeed, in the light of the history which we have given and of the decision in the *Pollock Case* and the ground upon which the ruling in that case was based, there is no escape from the conclusion that the Amendment was drawn for the purpose of doing away for the future with the principle upon which the *Pollock Case* was decided, that is, of determining whether a tax on income was direct not by a consideration of the burden placed on the taxed income upon which it directly operated, but by taking into view the burden which resulted on the property from which the income was derived, since in express terms the Amendment provides that income taxes, from whatever source the income may be derived, shall not be subject to the regulation of apportionment."

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[2] The proposed amendment read as follows:

"[H.J. Res. 314, Sixty-seventh Congress, fourth session.] Joint Resolution Proposing an amendment to the Constitution of the United States. *Resolved by the Senate and House of Representatives of the United States of America in Congress assembled (two-thirds of each House concurring therein),* That the following article is proposed as an amendment to the Constitution of the United States, which shall be valid to all intents and purposes as part of the Constitution when ratified by the legislatures of three-fourths of the several States:

"ARTICLE —.

"Section 1. The United States shall have power to lay and collect taxes on income derived from securities issued, after the ratification of this article, by or under the authority of any State, but without discrimination against income derived from such sercurities and in favor of income derived from securities issued, after the ratification of this article, by or under the authority of the United States or any other State.

"Section 2. Each State shall have power to lay and collect taxes on income derived by its residents from securities issued, after the ratification of this article, by or under the authority of the United States, but without discrimination against income derived from such securities and in favor of income derived from securities issued after the ratification of this article, by or under the authority of such State."

The *Brushaber* case was decided on January 24, 1916. On February 21, 1916, the Supreme Court handed down the decision in *Stanton* v. *Baltic Mining Co.*, 240 U.S. 103 (1916). The decision was unanimous and again the Court reiterated the rule ". . . that the provisions of the Sixteenth Amendment conferred no new power of taxation . . ." 240 U.S. at 112.

In *Peck & Co.* v. *Lowe*, 247, U.S. 165 (1918), the Supreme Court decided that the net income of a corporation derived from exporting goods was not a tax on exports prohibited by the Constitution. The unanimous opinion of the Court stated: "The sixteenth amendment, although referred to in argument, has no real bearing and may be put out of view. As pointed out in recent decisions, it does not extend the taxing power to new or excepted subjects, but merely removes all occasion, which otherwise might exist, for an apportionment among the States of taxes laid on income, whether it be derived from one source or another." 247 U.S. at 172–3.

Two years later, in *Eisner* v. *Macomber*, 252 U.S. 189, 206 (1920), the Court said: "As repeatedly held, this did not extend the taxing power to new subjects, but merely removed the necessity which might otherwise exist for an apportionment among the States of taxes laid on income."

In 1926 in *Metcalf & Eddy* v. *Mitchell*, 269 U.S. 514, 521, Mr. Justice Stone flatly declared: ". . . the sixteenth amendment did not extend the taxing power to any new class of subjects."

Five years later, in *Willcuts* v. *Bunn*, Chief Justice Hughes, 282 U.S. 216 (1931), speaking for a unanimous Court which held capital gains on the sale of public securities to be taxable, reiterated the rationale of the rule as follows: "In the case of the obligations of a State or of its political subdivisions, the subject held to be exempt from Federal taxation is the principal and interest of the obligations. *Pollock* v. *Farmers' Loan & Trust Company, supra.* These obligations constitute the contract made by the State, or by its political agency pursuant to its authority, and a tax upon the amounts payable by the terms of the contract has therefore been regarded as bearing directly upon the exercise of the borrowing power of the Government."

Again in *James* v. *Dravo Contracting Co.*, 302 U.S. 134, 153 (1937) Chief Justice Huges restated the reason for income tax immunity of state and municipal bond interest as follows: "There is no ineluctable logic which makes the doctrine of immunity with respect to government bonds applicable to the earnings of an independent contractor rendering services to the Government. That doctrine recognizes the direct effect of a tax which 'would operate on the power to borrow before it is exercised' (*Pollock* v. *Farmers Loan & Trust Co., supra*) and which would directly affect the Government's obligations as a continuing security. *Vital considerations are there involved respecting the permanent relations of the Government to investors in its securities and its ability to maintain its credit, considerations which are not found in connection with contracts made from time to time for the services of independent contractors.*" (emphasis supplied)

And again, in *Helvering v. Mountain Producers Corporation*, 303 U.S. 376, 386 (1938) the Chief Justice repeated that: "a tax on the interest payable on state and municipal bonds has been held to be invalid as a tax bearing directly upon the exercises of the borrowing power of the Government (*Weston* v. *Charleston* ***, *Pollock v. Farmers' Loan & Trust Co.* ***)."

In the previous year Mr. Justice Cardozo had also pointed out in *Hale* v. *Iowa State Board*, 302 U.S. 95, 107 (1937): "By the teaching of the same (*Pollock*) case an income tax, if made to cover the interest on Government bonds, is a clog upon the borrowing power such as was condemned in *McCulloch* v. *Maryland* *** and *Collector* v. *Day* ***."

And in *Helvering* v. *Gerhardt*, 304 U.S. 405 (1938), in upholding a federal income tax as applied to salaries of the employees of the Port Authority, Chief Justice Stone also referred to the hazard of impairing the borrowing power, stating that the immunity doctrine had been sustained "where *** the function involved was one thought to be essential to the maintenance of a state government: as where the attempt was *** to tax income received by a private investor from state bonds, and thus threaten impairment of the borrowing power of the state, *Pollock* v. *Farmers' Loan & Trust Company*, 157 U.S. 429; cf. *Weston* v. *Charleston, supra*, 465–466."

The rationale of the *Helvering* v. *Gerhardt* case was followed in *Graves* v. *New York ex rel O'Keefe*, 306 U.S. 466 (1939) in which the Court held that the salary of an employee of the Home Owners Loan Corporation was not immune from state income tax. Both these cases relate to the same question whether intergovernmental immunities extend to the salaries of employees: *Gerhard* to a federal income tax applicable to state employees and *O'Keefe* to a state income tax applicable to federal employees.

It is noteworthy that in the *Gerhardt* case Mr. Justice Stone pointed out that the *Pollock* case had no application because, as distinguished from the income taxation of public salaries, the income taxation of public securities would "threaten impairment of the borrowing power of the state." The *O'Keefe* case does not refer to the *Pollock* case, probably because of the Government's position that the income taxation of public securities was essentially different.

In his argument in *Graves* v. *O'Keefe* before the Supreme Court, Solicitor General Robert Jackson, later Justice of the Supreme Court, had explained that the Government accepted the distinction drawn by Chief Justice Stone in the *Gerhardt* case and had emphasized that where one deals with a debtor-creditor relationship, the borrower is the one who is burdened. The Solicitor General said that it was *the presence of an actual burden upon the public instrumentality which issues public securities which distinguished the taxation of the interest on public securities from the taxation of the salaries of public employees.*

More recently, the Supreme Court has invalidated federal regulation which unduly interfere with the performance of sovereign or governmental functions of the states. In *National League of Cities* v. *Usery*, 426 U.S. 883, 855 (1976), the Supreme Court held unconstitutional the application of the Fair Labor Act's minimum wage and maximum hour provisions to the states. The opinion states: "Congress may not exercise * * * power so as to force directly upon the states its choices as to how essential decisions regarding the conduct of integral governmental functions are to be made."

Like the application of the Fair Labor Standards Act considered by the Supreme Court in *National League of Cities* v. *Usery*, the imposition of a tax on the obligations of the states (as well as their political subdivisions) would "operate to directly displace the States' freedom to structure integral operations in areas of traditional governmental functions" (426 U.S. 852) by increasing pressures on state budgets, a natural result of higher borrowing costs caused by the diminution in value of interest received by the holders of state obligations. The borrowing power of the states (as well as their political subdivisions) is certainly central to their ability to conduct their traditional operations and to provide the services traditionally furnished by them to the public.

The evidence is overwhelming that the views of Congress and the Supreme Court on the scope of the Sixteenth Amendment correctly express the purpose and meaning of the Amendment. That purpose was to permit Congress to levy and assess taxes on income without complying with the impracticable rule of apportionment according to population. Before the Amendment, Congress had the power to lay income taxes, but not without apportionment. After the Amendment, Congress need not apportion. The history of the Amendment proves that it was never intended to repeal the constitutional doctrine of reciprocal immunity from taxation of state and federal instrumentalities and obligations.

3. The history of the adoption of the Sixteenth Amendment confirms the Congressional and Supreme Court construction of its intent and meaning.—Sixty years ago President Taft sent a special message to Congress in which he urged a constitutional amendment which would confer upon the national government "the power to levy an income tax * * * without apportionment among the states in proportion to population."

The President urged Congress not to reenact the 1894 income tax law which had been declared unconstitutional, saying: "For the Congress to assume that the court will reverse itself, and to enact legislation on such an assumption, will not strengthen popular confidence in the stability of judicial construction of the Constitution." 44 Cong. Rec. (June 16, 1909) p. 3344.

Previous to President Taft's special message, Senator Brown of Nebraska had offered a resolution for a constitutional amendment to the effect that "The Congress shall have power to lay and collect taxes on incomes and inheritances." Upon being informed in debate that Congress already had both the powers in question and that only the rule of apportionment stood in the way of federal income taxation, Senator Brown offered, a few days later, a second resolution which read that "The Congress shall have power to lay and collect direct taxes on incomes without apportionment among the several states according to population." 44 Cong. Rec. pp. 1548, 1568-9, 3377. The Senate Finance Committee soon reported a resolution for a constitutional amendment in which the words "direct taxes" were changed to "taxes" and after "income" the words "from whatever source derived" were inserted. The proposed amendment then read: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." 44 Cong. Rec. p. 3900.

The Committee gave no explanation of the reason for these changes.[3] However, the reason for the two changes is clear. The words "direct taxes" in Senator Brown's proposal would require explanation because it was not obvious why the amendment should only provide that direct taxes need not be apportioned. Hence, to eliminate the ambiguity of "direct taxes" the committee provided that taxes on income "from whatever source derived" need not be apportioned. Senator Brown's proposed amendment as clarified by the Senate Finance Committee did not grant power to Congress to lay and collect a tax on incomes; Congress already had plenary power to levy income taxes under Article I, Section 8 of the Constitution (quoted supra at p. 6). The phrase "from whatever source derived" was simply another way of saying that Congress need no longer apportion any tax on incomes, irrespective of the source of the income; that was the sole purpose of the Amendment proposed by President Taft and introduced by Senator Brown.

The debate in Congress took one day in the Senate and one day in the House. The joint resolution proposing the amendment as redrafted by the Committee passed both houses and was immediately submitted to the states. No consideration was given at all to the question of the taxation of income from state and municipal bonds. The matter simply was not discussed. There was no indication that anyone sought to overturn the doctrine that state and municipal bond interest was immune from federal taxation which had been unanimously established in the *Pollock* case.

On January 5, 1910, Governor Hughes of New York submitted the amendment to the Legislature with a message calling attention to the words "from whatever source derived," suggesting that this might permit the taxation of income from state and municipal obligations, and questioning whether the amendment should be ratified.

On February 10, 1910, Senator Borah spoke in the Senate in answer to Governor Hughes' objection, stating in substance that no such meaning could be attached to the amendment. 45 Cong. Rec. 1694-9. He was followed by Senator Brown who concurred with Senator Borah's interpretation. Later, Senator Brown pointedly suggested that Governor Hughes stood alone in his fear.

"It is a very significant fact that this amendment which was pending in Congress for days and was the subject of discussion by Congress and the press, should never have met this criticism while it was pending. In its present form it had the support of a unanimous Senate and a practically unanimous House of Representatives, who were all, judged by their votes, in favor of conferring this power on Congress, and yet no one in Congress ever suggested any change in the language of the resolution or proposed an amendment thereto to cover the objection now made.

"Nor did any distinguished Governor from any of the 46 States, all of whom are now very loud in their protestations that the Government should have the power to tax incomes without apportionment, ever suggest that the amendment should have been modified in form in any respect. In this body the State of New York enjoys representation of the very highest character and most eminent ability, and yet New York on the roll call, as shown in the Congressional Record, was in favor of this amendment as it passed Congress, and was silent as to any suggestion that the language was faulty.

* * * * * * *

"The amendment does not alter or modify the relation today existing between the States and the Federal Government. That relation will remain the same under the amendment as it is today without the amendment. It is conceded by all that the Government cannot under the present Constitution tax state securities or state instrumentalities." 45 Cong. Rec. 2245–6 (Feb. 23, 1910).

On February 17, 1910, Senator Elihu Root of New York, a strong advocate for the amendment, wrote to New York State Senator Davenport giving his reasoned opinion that the amendment did not affect the immunity of state and municipal obligations. Senator Root wrote:

"Much as I respect the opinion of the Governor of the State, I cannot agree with the view expressed in his special message on January 5, and as I advocated in the Senate the resolution to submit the proposed amendment, it seems appropriate that I should state my view of its effect.

* * * * * * *

"The proposal followed the suggestion of the Supreme Court in the *Pollock* case.

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[3] The only colloquy which took place when the revised resolution was reported to the Senate is found in 44 Cong. Rec. 3900.

"The evil to be remedied was avowedly and manifestly the incapacity of the National Government resulting from the decision that income practically could not be taxed when derived either from real estate or from personal property, although it could be taxed when derived from business or occupation.

"The terms of the amendment are apt to cure that evil and to take away from the different classes of income considered by the court a practical immunity from taxation based upon the source from which they were derived." 45 Cong. Rec. p. 2539–40 (Mar. 1, 1910).

Thus, three United States Senators sought to allay any doubt held by Governor Hughes. No other member of Congress or any Governor [4] expressed any other view. That Governor Hughes' doubts were set at rest is shown by his opinions after he became Chief Justice, in *Willcuts* v. *Bunn (supra, p. 13), James* v. *Dravo Contracting Co. (supra, p. 13)* and *Helvering* v. *Mountain Producers Corporation (supra, p. 14).*

No one would doubt that if the states and their municipalities were to attempt to impose state or local taxes upon interest received by their residents from obligations of the Federal government, such a levy would be unconstitutional in the absence of consent by Congress to such taxation. *Weston* v. *City of Charleston,* 2 Pet. (U.S.) 449 (1829). And this is so even though it is universally accepted that the state legislatures possess plenary power to tax, subject only to the limitations of their state constitutions.

It is our opinion that the unanimous holding in the *Pollock* case, reaffirmed so many times after the Sixteenth Amendment, that interest on state and municipal securities is free from Federal income taxation under the Constitution would be again reaffirmed by the Supreme Court and that therefore any bill considered by this committee which would impose a minimum tax applicable to such interest would be unconstitutional.

C. To the extent that a minimum tax would apply to interest on local housing authority and agency obligations it would also be unconstitutional under the Fifth Amendment

It is our opinion that if a minimum tax applied to the interest on bonds of local public housing authorities issued to finance low rent housing, slum clearance and urban renewal projects, the tax would violate the Fifth Amendment to the Constitution.

The United States Housing Act of 1937 provides as follows: "Obligations, including interest thereon, issued by public housing agencies in connection with low-income housing projects shall be exempt from all taxation now or hereafter imposed by the United States." 42 U.S.C.A. 1437i(b).

The Housing Act of 1949 provides as follows: "Obligations, including interest thereon, issued by local public agencies for projects assisted pursuant to this subchapter, and income derived by such agencies from such projects, shall be exempt from all taxation now or hereafter imposed by the United States." 42 U.S.C.A. 1452(g).

Each of the above-quoted provisions of the United States Housing Act of 1937 and the Housing Act of 1949 that the obligations of local housing authorities and agencies "including interest thereon * * *" shall be exempt from all taxation now or hereafter imposed by the United States constitutes a statutory contract between the federal government and the holders of such obligations. In our opinion, to deprive such holders to any extent of their immunity from federal taxation on the interest which they receive from such obligations impairs the obligation of the contract in violation of the Fifth Amendment which "protects rights against the United States arising out of a contract." *Lynch* v. *United States,* 292 U.S. 571 (1933). See also *Farmers and Mechanics Savings Bank* v. *Minnesota,* 232 U.S. 516, 528 (1913).

Dated: April 13, 1982.

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[4] In a message to the New Jersey Legislature, dated February 7, 1910, John Franklin Fort, Governor of New Jersey, said: "* * * Nor am I inclined to accept the statement that the Supreme Court of the United States might construe the words 'from whatever source derived' as found in the pending amendment as justifying the taxing of the securities of any other taxing power."

On February 23, Senator Brown, referring to the message of Governor Fort, of New Jersey, said: "It cheers our hearts to read in the press that President Taft agrees with the Governor of New Jersey, who, in a message to his legislature February 7 and since the New York message was transmitted, took immediate and direct issue with the governor of New York." (45 Cong. Rec. p. 2245)

STATEMENT OF DOUGLAS L. DRUMWRIGHT, VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, HOMESTAKE MINING CO.

Mr. Chairman and Members of the Committee: Homestake Mining Company is grateful for this opportunity to submit a written statement on Revenue Increase Proposals contained in the Administration's fiscal year 1983 budget.

Homestake is the largest gold producer in the United States, with significant production also of silver, uranium, lead metal, lead and zinc concentrates. Like other mining companies, Homestake necessarily commits sizeable funds for mineral exploration. Without an active exploration program any mining company venture is due for an early demise.

During the past year alone, Homestake spent approximately $22 million on exploration.

We strongly oppose the Administration's proposal to add mining exploration and development cost to the list of tax preference items for the corporate minimum tax. This proposed change would constitute a serious obstacle to the Nation's goals of industrial revitalization and mineral self-sufficiency.

The ability to finance exploration programs is essential to the existence of the mining industry, much as research is essential to the vitality of the manufacturing industry. The Administration's proposal to impose a 15 percent penalty on mining exploration expenses in incongruous with the special tax credits applicable to the research expenditures of non-mining companies incorporated in the Economic Recovery Tax Act of 1981. Mining exploration should be encouraged by federal tax policy, not dissuaded by it.

Mining exploration is an essential high-risk activity of mining companies. Historically, only a tiny fraction of the mining prospects achieve commercial viability. Accordingly, mining exploration costs are charged to expense as incurred; similar to the expensing of research costs by other industries. Inclusion of exploration as a preference item could result in payment of minimum tax when a mining company is operating at a loss.

The tax policy allowing mine development to be expensed currently, in most instances, is already less favorable than the combination of accelerated depreciation under ACRS and the investment tax credit which is allowed non mining industries on their additions to plant and equipment. Classification of mine development costs as a preference item would place an additional discriminatory burden on the capital-intensive mining industry, particularly during periods of low metal prices and correspondingly low or nonexistent earnings. This proposal would be particularly burdensome to nonintegrated mining companies which have no other nonmining income to shelter preference items.

We strongly urge members of the Committee to reject the proposal to classify mining exploration and development costs as tax preference items. Approval of this proposal would have a severe adverse impact on a mining company's capabilities of maintaining the viable exploration programs that will be needed to supply the country's vital need for minerals from stable domestic sources.

This severe adverse impact poses the horrendous prospect of forcing cost-cutting and thereby adding to the unemployment crisis already facing the nation's economy. The end result would be the opposite of what the Administration is seeking. The Department's regressive proposal threatens a decrease in revenue-creating activities by the mining industry, its allied suppliers, and ultimately results in severely reduced tax revenue to the government.

HORST CONSTRUCTION CO.,
New Holland, Pa., April 5, 1982.

Hon. DAN ROSTENKOWSKI,
U.S. Senate,
Washington, D.C.

DEAR SENATOR ROSTENKOWSKI: I was deeply disturbed to learn that the Administration has proposed to eliminate the use of the completed contract method of reporting income for tax purposes. In this year of high interest rates and inflation, it is difficult enough to make ends meet without being required to pay taxes on a contract before I have the cash, or know if the contract will yield a profit. Using the completed contract method, Horst Construction has been able to meet its fair tax obligations as they become due. However, if Horst Construction is forced to start paying taxes immediately on contracts that are in a positive cash flow position while deferring deductions on contracts in a negative cash flow position, it will have to borrow money to finance tax payments. Few banks would be willing to loan

money for tax payment. With the economy in its present condition, this new burden could well force Horst Construction out of business or severely restrict its business activities. I hope you will closely scrutinize these proposals. They are poorly thought out and are not in the best interest of the American public.

Sincerely yours,

ABRAM S. HORST, JR., *President.*

HOSPITAL FINANCIAL MANAGEMENT ASSOCIATION,
Oak Brook, Ill., April 16, 1982.

DAN ROSTENKOWSKI,
Chairman, House Ways and Means Committee,
Washington, D.C.

DEAR MR. ROSTENKOWSKI: The Hospital Financial Management Association (HFMA) has grave concerns about the effect on hospitals, nursing homes and other healthcare organizations of the Treasury Department's proposed restrictions on tax-exempt bond financing. HFMA respresents 21,000 individual members who are financial managers of healthcare providers or who are closely associated with the financial management of healthcare organizations. These are the individuals who arrange capital financing and deal daily with the impact of various capital financing decisions on operations of healthcare organizations.

Access to capital is essential to any organization's existence. The cost of capital is an important aspect of any organization's cost. HFMA members are concerned about the effect of the Treasury Deparment's proposal on both availability of capital and cost of operations.

First a few misconceptions must be clarified. Healthcare organizations are important community resources operated for the public interest. It is therefore inappropriate to characterize the use of tax-exempt financing by these as being "for private activities." Tax-exempt financing has not been primarily used for expansion but to refinance higher cost debt or to modernize and renovate existing facilities. In fact, between the years 1976 and 1979, hospital construction actually declined by 24 percent when viewed in constant dollars. Over 70 percent of total hospital construction during this time was related to projects that had no effect on bed capacity.

The recent growth in use of tax-exempt financing by healthcare organizations coincides with the winding down of government's long and costly Hill-Burton program of providing capital funds to hospitals. In order to meet their continuing community obligations, these organizations will have continuing need for capital—estimated to be $230 billion between 1980 and 1990.

Any action which undermines access to this capital has serious public policy implications. Furthermore, a policy change such as that proposed which discriminates against tax-exempt organizations, can seriously distort relationships within the industry.

The Treasury's quest for more tax revenue also has serious implications to the cost of healthcare operations. As a result of government policy, healthcare cost is already rising rapidly. The present government policy, in fact, exacerbates this rise by shifting costs to other payors. Healthcare organizations must have and will obtain capital funds. Adoption of the Treasury proposal will doubtless raise the cost of capital to these organizations thereby accentuating the cost rise to the federal government itself through Medicare, to the states through Medicaid and to the economy in general. Such action will complicate and confuse other congressional deliberations about ways to control healthcare costs.

The Treasury's proposals to add yet another layer of approval to the already extensive and overlapping approval process will delay projects and add to cost. The proposal to require local government contributions to a project will restrict the availability of improved health facilities to communities with economic problems—likely the communities most in need. Cost will also be increased by provisions for Internal Revenue Service registration or by limits on earning on short-term investment of funds.

An excellent article, "Congressional Threat? Tax-exempt Hospital Bonds: Key Questions and Answers" by George C. Phillips, Jr., was published in our Association's HFM Journal in April. A copy is attached for your further information. [Article retained in the committee hearing file.]

The Treasury Department's proposed limits on tax-exempt bonds should not be applied to healthcare organizations because these rules will limit the availability of capital unnecessarily and in a manner which will create distortions in the industry and cause costs of increase unnecessarily. Such a result will unduly complicate the

government's efforts to contain costs. We urge that the Treasury Department proposal not be applied to healthcare organizations' use of tax-exempt financing.

Sincerely,

JAMES T. WHITMAN, *President.*

STATEMENT OF JOHN D. KRAMER, SECRETARY, ILLINOIS DEPARTMENT OF TRANSPORTATION

This is another important year for Ways and Means as the focus is on reviewing proposals to enhance revenues from existing sources. Understandably, Congress is devoting much attention to the task of reviving the economy and reducing the federal deficit. The task is difficult, but unavoidable. There is a growing realization that there is a limit to cutting or neglecting federal programs and reducing or containing taxes without incurring costs in the future far greater than the costs we are attempting to reduce now. This is particularly the case with the federal surface transportation program which this statement addresses. This Committee's review should include looking at possibilities for enhancing revenues used to preserve the nation's transportation system.

Transportation revenues

Revenues for transportation have been eroding steadily since the mid 1970's when the Arab oil embargo delivered a landmark blow to this nation's energy consumption habits and outlook. While other areas affected by this watershed event have sought and found ways to readjust, we have stood by, watching the growth in transportation revenues turn stagnant. The results of this inaction are coming in—serious and permanent transportation funding short-falls.

For example, in fiscal year 1981 for the first time, Highway Trust Fund user fee revenues fell $1.8 billion short of expenditures. If the 1981 expenditures would have reflected actual program needs, the gap would have been far greater still. The development of this gap was inevitable, given the fact that the 4 cent per gallon fuel tax has remained constant since 1959 while construction costs have increased by 300 percent. Serious funding short falls have also begun to strain public transportation systems.

Current revenues can no longer provide the level of funding needed for maintaining a transportation system that is adequate for today's needs.

Economic impact

This funding short-fall affects not only transportation, but also the nation's economic health which depends on an efficient transportation system to move people and goods and to spur productivity. The transportation network is the lifeline for economic activity. It is essential for moving raw materials to production centers. It is essential for distributing finished goods to domestic and foreign markets. It directly affects people's daily lives by meeting their mobility needs for professional and personal reasons. Finally, transportation is an industry by itself that constitutes a significant portion of the nation's work force and contributes substantially to the GNP. Over 20 percent of the GNP is generated from the transportation of goods and people.

Given this relationship, transportation is a key element in our nation's overall economic direction. Increasing revenues to meet our transportation needs would thus help meet our goal of achieving economic recovery.

Transportation needs

Our transportation needs are immense and growing. Much of the nation's transportation system has reached an advanced age, necessitating major repairs and improvements to keep it working for today's and tomorrow's needs. The funding shortfall is beginning to take its toll in deferred maintenance and construction. The cost of deferring work is great; simple repairs, if neglected, will rapidly lead to major rebuilding projects, with a price tag two to three times greater than that of a repair job.

Take highways, for example. Roads ideally last between 20 and 30 years before major repairs are needed. A substantial portion (nearly 40 percent) of our highway network was built more than 25 years ago. More than 50 percent of the Primary system will reach the end of its design life during the 1980's. One out of every five highway bridges on the Federal-aid system is classified as deficient for handling today's traffic, which means either restricted to light vehicles, closed to traffic or in need of immediate repair.

The Interstate system, begun in 1956, is not even complete, yet it is already crumbling. The proportion of Interstate mileage in "good" condition dropped from 71 per-

cent to 60 percent between 1975 and 1978. During the same period, Interstate mileage in need of immediate resurfacing more than doubled, from 4 percent to 9 percent. Today, approximately 4,000 miles require immediate resurfacing. Interstate 4R needs are expected to cost $37 billion during the next 10 years. The Interstate transfer progam has an unfunded balance of $5.7 billion nationwide with $2.4 billion, or 34 percent, representing transfer projects in the Chicago area alone. Past funding levels have had little impact in reducing the balance. In fact, the current balance is even larger than it was two years ago; the $1.7 billion in fiscal year 1981 and fiscal year 1982 appropriations have been more than offset by the $1.9 billion in additional Interstate withdrawals and by adjustments for inflation. Urban areas are badly in need of getting these projects completed.

The situation is not much different for public transportation. A number of the larger systems are on the brink of insolvency with stop gap measures and crisis management often pre-empting balanced and long-range capital and maintenance planning. Federal revenues available for operating assistance have declined in real dollars in the last two years while the cost of running systems has increased dramatically. Transit capital needs, including new starts, over the next decade will cost more than 10 times the projected available funds. Some of the older cities, such as New York and Chicago, are faced with serious deterioration of their transit infrastructures due to aging. Chicago's elevated system, much of it built in the 1980's and totally completed by 1920, is wearing out and will require major renovation and replacement.

Adequate funding is needed to keep transit equipment and facilities in working order and to expand service where it is justified. Properly maintained equipment and facilities are essential to meet the service demands placed on systems nationwide by nearly one billion commuters daily. Without federal funding, this crucial component will be short-changed and neglected as local transit districts strain to take over growing operating expenses. Further, continuing the federal involvement in transit capital and maintenance expenditures is necessary to assure an overall balance in the transportation system, especially in urban areas where inadequate federal funding for transit would place overwhelming demands on already congested highway systems.

Transportation clearly serves a fundamental need in people's daily lives and is an indispensable element in the nation's economy. The cost of allowing the nation's transportation infrastructure to crumble is incalculable.

It seems that the option is not whether to increase transportation revenues, but by what means. I would like to present for your consideration two transportation revenue enhancement options:

Raising federal transportation user fees by an equivalent of a 5 cent per gallon gas tax, as proposed by US Transportation Secretary Drew Lewis.

Earmarking a portion of the proposed crude oil import tax for transportation purposes.

User-fee increase

This option which includes setting aside one-fifth of the revenue for public transportation, would generate approximately $5.7 billion a year, with $4.6 billion for highways and another $1.1 billion for a federal public transit program. User fees have been accepted as a fair and an appropriate method of financing transportation programs and public support for an increase is growing.

The time is right for an update of this revenue source, particularly the gas tax, which has been the same for over 20 years. In 1959, the 4 cent federal tax represented 13 percent of the average cost of a gallon of gasoline. Today, that same tax represents only 3 percent of the cost of a gallon of fuel. In 1959, a typical motorist driving 10,000 miles a year, contributed $28 in federal fuel revenues; today's motorist, driving the same number of miles a year, but with a more fuel efficient new car, contributes only $16.

The Transportation Secretary's proposal enjoys a broad spectrum of support. Groups endorsing the user fee increase include the American Association of State Highway and Transportation Officials, American Road and Transportation Builders Association, the US Conference of Mayors, the Railway Progress Institute, the Associated General Contractors, the American Public Works Association, the Institute of Transportation Engineers and the American Public Transit Association.

Individual motorists are also realizing that better roads are worth the additional user fees. Road improvements will result in substantial savings in the cost of operating and maintaining vehicles. Furthermore, better roads are safer roads. A study by the Road Information Program research group has found that in 1979, obsolete roads contributed to 21.4 percent of all motor vehicle accidents at a cost of $8.55

billion in accidential death benefits, medical care, loss of earnings and property damage.

Setting aside $1.1 billion of the increase for public transportation makes a great deal of sense because of public transit's indispensable role in moving masses of people in large urban areas where scarcity of land and environmental considerations limit highway construction and the number of cars that can be accommodated. Public transit takes commuters out of their cars, which reduces the demand for highway expansion and wear and tear on the existing system. Reserving a portion of the revenue increase for public transit recognizes its significant contribution to the overall transportation system.

Crude oil import tax

A crude oil import tariff of $5 per barrel has been proposed to Congress and the White House. This is expected to generate approximately $13 billion a year. Given the fact that transportation uses approximately half of all the petroleum consumed in this country, a substantial portion of these revenues could be channeled to transportation purposes. This tariff, which has been proposed primarily to help reduce the federal deficit, will also help keep oil consumption constant by counteracting the current drop in foreign oil prices. Transportation revenues have been greatly affected by the success of energy conservation. Therefore, a portion of the tax that will further the goal of energy conservation should be available to offset the impact on transportation revenues.

Mr. Chairman and members of this Committee, now is a good time to consider raising and enhancing transportation user fees. Gasoline prices are on a temporary down-swing due to the current foreign oil surplus. The equivalent of a 5 cent per gallon increase or an import tax on crude oil are, therefore, easier to absorb. Either option could serve as a stabilizer of the public's consumption pattern, thereby working to prevent another energy crisis in the future when the surplus situation comes to end and scarcity resumes once again.

Now is the time we must act to increase revenues in order to preserve the nation's transportation investments. It will be less costly in the long run to make needed repairs and improvements before deterioration of the infrastructure becomes irreversible. An adequate and well maintained transportation system is an integral element to this country's economic progress and health. Our highway system in particular provides basic access to business and production centers and link-ups to all other transportation modes for people and for freight.

Increasing transportation revenues now will boost the nation's economic recovery by creating jobs in construction, one of the more hard-hit areas of unemployment. Construction jobs have a significant impact on other employment as well. Each construction job generates three service jobs.

As I have discussed, the need for improved transportation funding is critical and the opportunity is before us to meet this challenge. I urge this Committee to consider the options I have outlined above. Thank you for this opportunity to comment.

STATEMENT OF LAWRENCE R. LUCAS, ILLINOIS ROAD BUILDERS ASSOCIATION

Mr. Chairman and distinguished members of this Committee, on behalf of the Illinois Road Builders Association, I sincerely appreciate the opportunity to give this testimony today.

It is essential to look at the possibilities for enhancing revenues which are used to preserve the nation's transportation system. Since the mid-1970's the transportation system has been faced with serious funding short-falls. Current revenues can no longer provide the level of funding needed for maintaining a transportation system that is adequate for today's needs.

The economic impact of this funding short-fall affects not only the transportation system, but also the nation's economic health. The nation's economy depends on an efficient transportation system to move people, goods and to spur productivity. The transportation network directly affects people's daily lives by meeting their mobility needs for professional and personal reasons. Since transportation is a key element to the nation's overall economic direction, revenues must be increased to meet our present and future transportation needs.

Our transportation needs are immense and growing because of the rapid deterioration of our roads. The funding level has not kept pace with the costs of repairing this transportation system. The funding short-fall is beginning to take its toll in deferred maintenance and construction. The cost of deferring work is great; simple repairs, if neglected, will rapidly lead to major rebuilding projects, with a cost three to five times greater than that of a repair job. Therefore, the cost of allowing the nation's transportation infrastructure to deteriorate is exponential.

It appears that the option is not whether to increase transportation revenues, but by what means. The two transportation revenue enhancement options are:

1. Raising the federal transportation user fees by about a 5 cents per gallon gas tax, as proposed by the U.S. Transportation Secretary Drew Lewis.

2. Earmarking a portion of the proposed crude oil import tax for transportation purposes.

The user fee increase would generate approximately $5.7 billion a year, with $4.6 billion for highways and another $1.1 billion for federal public transportation.

The time is now for an increase in this user fee revenue source, especially since it has been the same for over 20 years. Individual motorists are realizing that road improvements will result in substantial savings in the cost of operating and maintaining vehicles. Therefore, the Illinois Road Builders Association supports the user fee increase proposed by Secretary Drew Lewis.

The crude oil import tax of $5 per barrel is expected to generate approximately $13 billion a year. It is proposed that a substantial portion of these revenues could be channeled for transportation purposes. Therefore, this tax will help offset any funding short-falls.

Now is the time we must act to increase revenues in order to preserve the nation's transportation system. An adequate and well maintained transportation system is an integral part of the nation's economic progress. However, it is critical that transportation funding be improved.

Statement of International Union, United Automobile, Aerospace and Agricultural Implement Workers of America, UAW

The International Union, UAW appreciates the opportunity of presenting our views on the tax proposals of the Administration for fiscal year 1983.

Enactment of anything closely resembling the Reagan fiscal year 1983 budget would preserve the tax inequities enacted in 1981, while the drastic erosion of the tax base would still cloud the future. Our country would be taken further down the path of dismantled social programs and a bloated military establishment.

Moreover, the Administration budget fails to address what has become the worst recession in the post-World War II period. Restrictive monetary policies and fiscal stringency during most of 1981, including cutbacks in social programs, have been a direct cause of the recession.

While the downturn in the entire economy started in mid-1981, industries like auto which are very sensitive to credit have been in a depression far longer. And their crisis shows no signs of abatement. As this is written, over 250,000 UAW members in the major auto corporations remain on indefinite layoff. Scores of thousands of others have lost their jobs in auto supplier shops, farm equipment companies, and construction equipment plants. Intelligent action is urgently needed to prevent further structural damage in these industries, which on their own and through their linkages to the rest of manufacturing have historically played a crucial role in employment and productivity growth. To pull the economy out of the recession, there must be a harmonious combination of expansive fiscal and monetary policies, rather than the conflicting measures of the present and recent past.

The UAW's revenue recommendations for fiscal year 1983 are based on the following premises:

A sizable deficit will be necessary to help pull the economy out of the present deep and protracted slump.

The 1981 Act riddled the tax system with inequities for individuals and loopholes for corporations, and deprived the federal government of the revenues needed to conduct a humane, employment-oriented social policy.

The principle that tax incentives for investment should not be confined to currently profitable companies must be preserved.

Accordingly, the UAW offers these specific proposals:

Restore the corporate income tax on profitable companies.—According to the President's own Council of Economic Advisers, as well as numerous other analysts, the corporate tax changes adopted last year will result in "negative" tax rates on the income from new investments for many profitable companies, and will virtually eliminate the corporate income tax over the long run. As a result, by 1987 corporations will bear only 7 percent of the federal tax burden, compared with 23 percent in the early 1960s. This shift in the tax burden to wage earners must be reversed. The corporate tax laws should be amended so that profitable companies are not allowed to totally escape the payment of taxes on their gross earnings.

Make the 1982 individual tax cut more equitable.—According to data from the Joint Committee on Taxation, most taxpayers—and the overwhelming majority of

our members—may not receive enough from the Reagan tax "cut" to offset their tax increases from higher Social Security taxes and "bracket-creep." High-income individuals, on the other hand, will receive real tax reductions totaling tens of thousands of dollars over the next three years. In 1982, this imbalance should be scaled back by (1) repealing the drop of the 70 percent rate bracket to 50 percent for unearned income, and (2) applying a progressive surcharge to taxes as scheduled to be paid beginning in mid-year.

This reduction in fiscal stimulus should be offset by increased spending on extended unemployment benefits and job and training programs beginning immediately.

Cap the 1983 tax cut at $700 per family.—This measure, already proposed by the AFL-CIO, would introduce some fairness in the 1983 individual tax cut by reducing the scope of the cuts. Starting at about $40,000, families would have their tax cut trimmed to $700 from the scheduled reduction. For a family of three at $50,000, the cut would be scaled back to $700 from $807; for a comparable family at $100,000, the cut would be scaled back to $700 from $2,511.

Replace the "safe-harbor" leasing rules with refundability of tax investment incentives to currently non-profitable corporations.—The UAW supports tax legislation to provide investment incentives to currently unprofitable companies which are viable in the long run, as evidenced by their continued investment in new equipment. However, "safe-harbor" leasing rules are an awkward an inefficient way of accomplishing this. Moreover, the new rules make undeserved tax credits available to profitable corporations which owe little or no taxes on account of other loopholes in the tax code. A more direct way of equalizing the cost of new investments and encouraging all industry to modernize is to refund the related tax advantages to companies which, because of low or zero profitability, do not generate enough tax liabilities to make use of such advantages. Some limitations on zero and low tax situations would be appropriate; for example, those resulting from foreign tax credits.

Repeal the loopholes in the Oil Windfall Profits Tax.—The 1981 Tax Act increased tax credits against the windfall tax for royalty owners, halved the tax rate on new oil, and exempted stripper oil from certain wells owned by independent producers from the tax. These measures have no justification on either economic or equity grounds and entail a high revenue loss.

Disallow reduced rates on the first $100,000 of corporate income for businesses earning over $100,000.—The law currently taxes corporate profits under a 5-step graduated tax rate structure; the lowest rates were reduced by the 1981 Act. The reason for this graduation is to benefit smaller, often labor-intensive businesses. However, extending the benefit to larger corporations is a windfall with substantial cost to the Treasury.

Change the estate and gift tax rules.—The 1981 Act reduced the proportion of estates that would be taxable from 2.8 percent to less than 0.3 percent, in effect bestowing a tax break on a group of very wealthy individuals, and practically eliminating the tax as a revenue raiser.

Repeal the indexation rules.—Starting in 1985, tax brackets and the personal exemption will be indexed to inflation. This will drastically curtail the federal government's ability to set social policy, as it amounts to a permanent erosion of the tax base.

These tax modifications constitute a necessary but still modest step in the direction of a more equitable tax system and one more capable of raising adequate revenues. Other costly provisions in the tax code in long-overdue need of reform include preferences for foreign-earned income, and for export profits (DISC), the expensing of oil and gas exploration and development costs, the special depletion allowances, and the special capital gains exclusion.

On the spending side of the budget, the UAW calls for fiscal year 1983 defense outlays $15 to $20 billion lower than the huge increases requested by the Administration. The public debate on military spending has uncovered many areas of prospective savings, such as the procurement of obsolete or useless equipment, cost overruns, and disproportionate military personnel pay raises.

On the other hand, we have identified a minimum of $25 billion of requested cuts in social programs from fiscal year 1983 current service levels which must absolutely be rejected by Congress. The affected programs span the entire range of social functions, and in many cases have already been weakened by cuts enacted in 1981. In addition, the gravity of the recession makes it imperative that training and public service employment programs be restored, and that extended unemployment insurance benefits and trade adjustment assistance benefits for workers displaced by imports be made available again.

While the private sector is being enticed by all sorts of tax preferences to carry on productive investment, there has been unconscionable neglect of our public infrastructure. There can be no healthy productivity growth if our highways, bridges and harbors are allowed to deteriorate, and if public investment fails to keep up with the facilities required in old and new communities. Accordingly, substantial funds in next year's budget should be allocated to public investment.

The Administration has taken a fragmented approach to the task of raising additional revenues in fiscal year 1983: we counted 24 proposals to raise $15.9 billion. This fragmentation practically assures that no revenue gains close to that total will be approved by Congress. Moreover, several of the initiatives, e.g., in the area of user charges, are inequitable; and the minimum tax proposed for corporations would recapture only a small fraction of the revenues given away to business by the 1981 Act.

The economic program of the Reagan Administration is in shambles. A brief look into the Administration's own economic assumptions in March 1981 and less than one year later shows the shortfall between its misguided expectations and reality:

ECONOMIC ASSUMPTIONS

[In percent]

	March 1981		February 1982	
	1981	1982	1981	1982
Real GNP change 4th quarter over 4th quarter	1.4	5.2	0.7	3.0
Unemployment rate 4th quarter	7.7	7.8	8.4	8.4
Interest rate, short term	11.1	8.9	14.1	11.7

Source: Office of Management and Budget.

Moreover, the assumptions of February 1982 have already become obsolete; the date of the recovery gets pushed back with the release of each batch of economic statistics. Meanwhile, the Administration's seemingly mindless determination to "stay the course" postpones the recovery even further.

In order to reverse this downward momentum, there must be a serious effort to put the unemployed back to work and get our manufacturing capacity in full use again. The budgetary measures proposed above are an indispensable part of this effort. So is an end to tight monetary policies; an adequate supply of credit at a reasonable interest rate is urgently needed to stimulate the economy and accommodate the expansion once it gets going.

UAW budgetary alternative to Reagan's budget, fiscal year 1983 impact (anticipated revenue [1])

	Billions
Revenue changes:	
Make 1982 individual tax cut more equitable	$5.0
Restore top marginal rate for unearned income	2.3
Cap 1983 individual at $700 per family	3.0
Restore taxes on profitable corporations	5.0
Repeal new loopholes in oil windfall profit tax	1.7
Modify the widened estate and gift tax provisions	1.0
Apply lower corporate income tax rates only to smaller corporations	7.0
Repeal future indexing of tax brackets	0
Total	25.0
Outlay changes:	
Reduce increase in military budget outlays	−15.0
Enact scrappage bounty for oldest cars	2.0
Restore proposed cuts	25.0
Extend unemployment compensation benefits, expand job training programs, and provide public service employment	8.0
Invest in public infrastructure	5.0
Total	25.0

[1] Approximate amounts.

NOTE.—The size of the fiscal 1983 deficit would not be affected by the above changes.

STATEMENT OF WILLIAM B. HOLMBERG, VICE PRESIDENT, KIDDER, PEABODY & CO., INC.

INTRODUCTION

I am William B. Holmberg, a Vice President of the investment banking firm of Kidder, Peabody & Co. Incorporated. My main area of professional involvement is public finance. I am the Managing Officer of the Corporate Services Group within Kidder, Peabody's Public Finance Department. In that capacity, I am responsible for all tax exempt financings on behalf of Kidder, Peabody's corporate clients.

Kidder, Peabody & Co. Incorporated was founded in 1865 and was incorporated in 1965. It is currently owned by 320 stockholders, all but one of whom are full-time employees. Kidder, Peabody employs approximately 3,500 persons, including more than 1,100 registered representatives, who staff 57 domestic and nine international offices.

In an industry that has been quite volatile, Kidder, Peabody has been consistently profitable for more than 40 years. Its hallmark has been not only its consistent profitability, but also its financial stability. Today, Kidder, Peabody benefits from a capital base in excess of $120,000,000. This capital consists primarily of equity and is allocated to the fundamental aspects of investment banking, thus giving Kidder, Peabody a strong, high-quality capital base.

As for public finance experience, Kidder, Peabody, in 1966, was the first major investment banking firm to establish a separate, full service Public Finance Department. Over the past eleven year, Kidder, Peabody has been the only firm which has consistently ranked within the top five managers of negotiated revenue bond issues each year according to Securities Industry Association and Public Securities Association Statistics.

In 1981, Kidder, Peabody participated in $24,096,000,000 of municipal bond financings, consisting of 592 different issues. This participation represents approximately 52 percent of the total municipal bond volume for 1981. During such year, Kidder, Peabody managed 279 municipal issues, totalling in excess of $8,600,000,000.

POSITION

During the present period of high interest rates, unemployment and recession, it is surprising that the Administration has proposed major cut-backs in the general use of industrial development bond (IDB) financing. IDB's often present the only feasible means by which to finance capital expenditures for socially desirable—often governmentally mandated—facilities. For this reason, the public nature and desirability of IDB's has long been recognized by Congress.

We agree with the original concept of the 1968 legislation—that no statutory exemption be available for IDB's except where the proceeds of such bonds are used to finance socially or economically desirable projects on the basis of community benefit. The Administration proposal, rather than addressing specific areas that could be considered abusive, broadly attacks IDB financings as a whole. This approach would result in the elimination of many worthwhile projects to the detriment of society. This statement will specifically address the ramifications of restricting financings in areas where there have been no abuses and where there are strong public policy reasons for continuing the existing IDB provisions.

ADMINISTRATION PROPOSALS

Exempt small issues

This is the primary area where abuses are alleged. Some reduction in such financings may be warranted. However, the Administration's proposal to restrict small issues beginning in 1983 on the basis of a $20 million capital expenditure test is overly restrictive. Kidder, Peabody supports legislative reform but perceives the Administration proposal would in many cases eliminate proper utilization of IDB financings.

Pollution control

Pollution control expenditures are for nonproductive government mandated facilities which have an obvious benefit to society but not to productivity. These expenditures are public in nature, and clearly should not be subject to any further restrictions.

The Administration proposal to restrict IDB financed property to straight line depreciation over an extended life constitutes a partial repeal of ACRS. No concern was raised that ACRS would provide undue benefits in the context of IDB financ-

ings when ACRS was adopted last year. To use the slight of hand reduction in ACRS for non productive facilities is unfair and would arbitrarily increase the costs of such facilities. Tax incentives in this area continue to be appropriate in light of the nation's environmental policy. Because public purposes continue to exist, IDB financing should continue and thus the Administration proposal makes no sense.

The Internal Revenue Service has already been overly restrictive in its interpretation of section 103(b)(4)(F) of the Internal Revenue Code. The law should be amended to make it clear that the most modern and efficient methods for pollution control quality for tax exempt financing, rather than restricting such financing to "end of pipe" technology. In addition, the formulas used for ascertaining economic benefit from such financing should be modified to insure that the costs and expenses of operation are properly accounted for before the financing is reduced. Finally, there is no justification for the Internal Revenue Service position which virtually eliminating financing of hazardous waste treatment facilities. At a time when we were trying to revitalize both our economy and our environment, there is no logic in restricting financing in this area. Moreover, restricting tax exempt financing for environmental facilities belies the fact that this is the only meaningful incentive in the Code for this type of activity. Finally, the accomplishments to date in this area are based largely upon this financing device.

Sewage, solid waste, and water facilities

The disposal of sewage and solid waste and the furnishing of water are clearly public functions. It is difficult to conceive that anyone would consider disposing of sewage and garbage as other than a public purpose. The need for IDB financing in this area is particularly exacerbated by the need for and requirements of environmentally safe systems. Recently adopted environmental standards have placed a tremendous additional cost on waste disposal and have forced communities to consider new, higher cost technologies. For example, landfill for garbage is being replaced by mass burn facilities which both dispose of wastes and have the added benefit of producing energy and recapturing valuable metals for recycling. Such facilities and serve many socially desirable goals. However, they will not be feasible without IDB financing due to the extensive capital required to construct them. If the Administration proposal were adopted, local governments would bear increased costs because debt service requirements and ACRS depreciation constitute major elements in establishing the necessary tipping fee which is charged by private enterprises in providing their services to a community. The facilities, under any method of financing or operation, are paid for by the general public using them.

Transportation facilities

Another area of obvious public concern is Section 103(b)(4)(D) of the Internal Revenue Code permitting financing of docks, wharves, and mass commuting facilities. Congress as recently as last year recognized the need for tax incentives for mass transportation facilities when it created a special rule in the safe harbor leasing area. These facilities benefit the public and are essential to the economy. For example, the major need for improved port facilities for the shipment of coal and other items is widely recognized.

The elements of the Administration proposal concerning approval by elected officials and governmental contributions appear to question the integrity of state and local authorities in an area where there have been very limited, if any, abuses. State and local authorities have generally been quite conscientious in the application of their powers to issue IDBs. Additionally administrative time and costs are not warranted, particularly when the Administration is seeking an overall reduction in such costs. The proposed further restrictions on investment yield would increase the size of bond financings with no apparent benefit to the Treasury, but with a definite increase in the cost of financing. There is no justification for this proposal. These restrictions affect all of the above mentioned areas of IDB financing as well as the housing and health care areas. It is clear that both housing and health care financing satisfy established public purposes.

Conclusion

Assuming Congress eliminates the socially less beneficial IDB financings and restricts abusive small issue financing, there is no rational for the other elements of the Administration proposal. Briefly, the exempt activities that have an inherent social benefit or that provide quasi public projects should continue under existing law. Kidder, Peabody supports true tax reform but believes Congress should not overlook the continuing need for tax exempt financing for the benefit of valid public purposes.

BETHANY, CONN., *April 14, 1982.*

DAN ROSTENKOWSKI,
Chairman, House Ways and Means Committee, House of Representatives, Washington, D.C.

DEAR REPRESENTATIVE ROSTENKOWSKI: I was deeply disturbed to learn that the Administration has proposed to eliminate the use of the completed contract method of reporting income tax purposes. In this era of high interest rates and inflation, it is difficult enough to make ends meet without being required to pay taxes on a contract before the cash is received, or know if the contract will yield a profit.

During my years in public accounting, and now involved with the construction industry in a private sector, I have seen first hand how the construction industry has relied on the tax advantages of the completed contract method. Using the completed contract method, construction companies have been able to meet their fair tax obligations as they become due. However, if these companies are forced to start paying taxes immediately on contracts that are in a positive cash flow position while deferring deductions on contracts in a negative cash flow position, they will have to borrow money to finance tax payments. Few banks would be willing to loan money for tax payments. With the economy in its present condition, this new burden could well force many construction companies out of business or severely restrict their business activities.

I hope you will closely scrutinize these proposals. They are poorly thought out and are not in the best interest of the American public.

Sincerely yours,

PETER M. LOHNE, CPA.

STATEMENT OF RICHARD S. HICKOK, CHAIRMAN OF MAIN HURDMAN

1. INTRODUCTION

My name is Richard Hickok. I am the Chairman of Main Hurdman, the ninth largest accounting firm in the United States and the fifth largest firm worldwide. We have over 80 offices in the United States. I also served as the Chairman of the American Institute of Certified Public Accountant's Construction Contractor Guide Committee which recently issued the new construction industry accounting guide. Although Main Hurdman has many clients that would be affected by the elimination of the completed contract method of reporting income for long-term contracts, I am submitting this written statement only as a representative of my firm and as a concerned citizen.

Through my long professional association with contractors both large and small, I personally have gained and understanding of the construction industry and I recognize the impact the Administration's proposal will have on that industry if it is enacted. I welcome this opportunity to express the views of Main Hurdman in opposition to the proposed elimination of the completed contract method and the impact of the proposal on the construction industry.

2. THE COMPLETED CONTRACT METHOD

The use of the completed contract method of accounting for long-term contracts and the associated treatment of period costs is not new. The initial predecessor to present Section 451 of the Internal Revenue Code of 1954 was enacted in 1916. The Regulations promulgated under the authority of Section 451 and its predecessors, which specifically allow the completed contract method, have been in substantially the same form since 1918. While there have been some adjustments to the language over the years, the principle involved has remained the same.

When it proposed the abolition of the completed contract method for reporting income from long-term contracts, the Administration stated that these long-standing rules have led to abuses. I will not deny that in many industries the use of the completed contract method can produce the abuses the Administration cites. However, the remedy is to correct the specific abuses. When only fine tuning is required, a wide-sweeping change is generally not the best approach.

For the construction industry, the adoption of the Administration's proposals would not be sound accounting and it would create identifiable financial hardships. The immediate reduction in cash flow to construction contractors under the proposal would force many businesses to change their mode of operations, to raise their prices to meet the higher costs of doing business and for the weaker members of the industry, to find relief in the bankruptcy courts.

3. FINANCIAL AND TAX ACCOUNTING ARE DIFFERENT

Financial accounting and tax accounting, although related in many respects, have different purposes. The 1979 decision of the Supreme Court in the *Thor Power Tool* case [(1979) 439 U.S. 522] effectively recognized this distinction when it ruled that inventory markdowns must be treated differently for financial and tax purposes. In that case, the Court stated [at page 542]:

"The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested . . . The primary goal of the income tax system, in contrast, is the equitable collection of revenue. . . ."

It is this very separation that created the problem we now face: the proposed elimination of the completed contract method. The Financial Accounting Standards Board (FASB) and the accounting profession, in their efforts to raise the standards of financial reporting are constantly taking initiatives to refine and improve accounting standards. These initiatives have significant importance for both the financial community and the general public, since the desired goal is to provide financial statements that most closely reflect the actual financial condition of an enterprise.

During 1981, the AICPA issued a new accounting guide for construction contractors recommending accounting methods for long-term contracts [Construction Contractors (New York: AICPA 1981)]. The guide generally recommends the percentage of completion method of accounting for financial reporting purposes. However, it also recommended the continuation of the completed contract method for tax purposes. Now proposed tax legislation appears to be tied to the AICPA's efforts to improve financial reporting standards. If this is allowed to happen, a cloud will be placed over the drafters of the improved accounting standards. They will fear that the proposals and explanatory statements they make in the effort to improve financial accounting standards will lead to tax legislation. No longer will this effort move in a free and open atmosphere.

It may not be too long before this effort to continually upgrade accounting standards will lose its momentum. The fear of tax legislation resulting from accounting modifications would become a paramount consideration of any deliberations. By adopting this proposed legislation, all that was established in the *Thor Power Tool* case—that financial and tax accounting are in fact separate—would be undermined.

4. THE COMPLETED CONTRACT METHOD SUITS THE CONSTRUCTION INDUSTRY OPERATING PROCEDURES

In reforming the tax laws, care should be taken not to destroy effective operating procedures. However, the adoption of the Administration's proposal to eliminate the completed contract method of accounting for tax reporting purposes will destroy a tax reporting method which has been effectively working in most instances for over 60 years.

The Administration's explanation of its proposal points to deferral periods "as long as 10, 15 or even 20 years. . . ." as one reason for seeking the change. However, lengthy deferrals are not a major problem in the contruction industry. In contrast, construction contracts have a fairly short life, although they commonly span two or more years. Generally, the construction contractor, has no desire to extend the life of a contract for tax avoidance or other purposes. The contractor merely wants to complete construction, have the project approved by the customer, collect retainages, pay taxes on realized profits and then move on to the next project.

The reason construction contractors want to finish their contracts as quickly as possible—apart from the fact that it makes good business sense—is that the usual contract payment schedule provides for retainages. These retainages or holdbacks are paid to the contractor at some point after the completion of actual construction, usually when the customer accepts that the contract was faithfully performed. It is a type of warranty security. In a great majority of cases, the retainage represents the profit from the contract. So even today, under current law, some construction contractors are faced with paying taxes on a completed contract before receiving the actual cash representing their profit.

It therefore follows that the completed contract method is not a loophole or disguished industry subsidy. It is a reporting method that is truly related to the economics and cash flow of the industry.

5. ADOPTING THE ADMINISTRATION'S PROPOSAL WILL HAVE A NEGATIVE IMPACT ON THE CONSTRUCTION INDUSTRY

A. Reduced cash flow

Now let us take a closer look at the impact of the proposals on the construction industry. In addition to eliminating the completed contract method, the proposals would continue the availability of the percentage of completion method. If the latter method was suitable, for tax purposes, the construction industry would have adopted it in force. However, this is truly not the case.

We can now turn to the newly proposed alternative: the progress payment method. If, as I noted before, the purpose of a tax reporting method is the "equitable collection of revenue," the progress payment method is not equitable. The progress payment method is an artificial creation that is purely arbitrary in operation and unrelated to business operations.

In a year in which a contract has a positive cash position, income will have to be reported without any relationship to actual profits. This is a shift in tax principles. Under the proposed progress payment method, tax would be levied on a positive cash flow, rather than on income. In addition, the positive cash flow would be measured on a contract by contract basis, rather than on all contracts.

Two simple examples can illustrate these problems of the progress payment method:

Example 1: In November, a calendar year construction company enters a contract to erect a building. Under the terms of the contract, the owner makes a $10,000 advance to the contractor to permit the purchase of materials for the project. If the progress payment method were adopted, the $10,000 is reportable income, in the year of receipt. Assuming a 50 percent rate, a tax of $5,000 must be paid leaving the contractor with $5,000. In January, when the materials are delivered, the contractor would only have $5,000 of the $10,000 advance available for the necessary payments to suppliers.

Example 2: A construction contractor enters three contracts during one year. Under the terms of contract (1), the contractor receives payment of 200 while paying expenses of 100. Therefore, contract (1) produces a positive cash flow position of 100. Under the terms of contracts (2) and (3), contractor receives payments of 50 per contract and pays expenses of 100 on each. This leaves the contractor in a negative cash flow position of 50 on each contract or a total of 100.

If the contractor is considered to be operating one business, the receipts and disbursements made pursuant to the contracts are aggregated and offset each other. There is no tax liability.

However, if, as is the proposal under the progress payment method, each contract must be considered separately, the contractor would have to pay a tax of 50 (using, for simplicity, a 50 percent tax rate) on the positive 100 cash flow of contract (1). This could not be offset by the negative cash flow of 100 from contracts (2) and (3). Therefore, at year end, instead of being in a balanced cash flow position, contractor has suffered a 50 negative cash flow.

	Contracts			Total
	(1)	(2)	(3)	
Cash flow:				
Income	200	50	50	300
Costs	(100)	(100)	(100)	(300)
Subtotal	100	(50)	(50)	0
Tax (50 percent)	(50)			(50)
Net	50	(50)	(50)	(50)

The result is that contractors will be called on to pay tax in those years in which there happens to be a positive cash flow on a contract. This does not mean that the contracts will in fact show a profit. It merely reflects the fact that at a certain point in time, receipts have exceeded the related deductible costs. However, it is at this point that the Administration has proposed that taxable income and the resulting tax liability are to be computed. I think it would be most difficult to justify this proposd method as an equitable means of collecting revenue.

The proposed reporting of income before a profit is realized presents a very difficult hurdle for construction contractors to overcome. Since they will be required to pay tax before they have the cash representing their profit, their cash flow will be severely reduced. The reduction in cash flow that would result from the adoption of the Administration's legislative proposals would force an inflationary change in the pricing of contacts, since construction contractors would have to reflect these increased costs when pricing a contract.

Generally, the pricing and bidding on contracts is completed in advance of the actual start of the operations. Assuming that experience and judgment have created the insight necessary to properly price a contract, not only will the bidding competition be won, but a profit will be earned on the competion and acceptance of the project.

However, since there is usually a delay in receiving the cash representing the profit (I previously described the retainage) many contractors borrow against their contracts to finance operations. This is in addition to using internally generated funds. Contracts presently reflect this.

If the Administration's proposals are adopted, the reduced cash flow caused by accelerated tax payments would prematurely deprive the construction contractor of the internally generated funds needed to finance the completion of long-term contracts. They will be forced to increase their borrowings at high interest rates. This could be difficult to accomplish. Although lenders are willing to make loans against a contract, they, generally, are not willing to lend money for the payment of taxes.

The construction industry was one of the first to be adversely affected by high interest rates. To force this proposed new system of taxation on this industry would further hinder any efforts to return to profitable operations and would surely drive more contractors into bankruptcy. The additional failures of construction contractors resulting from the enactment of this proposal could be devastating and would not benefit economic recovery efforts.

There is another facet of financing construction operations that is directly and adversely affected by the proposed progress payment method. The proposals indicate that any borrowings against the contract are to be treated as income. Thus, borrowings under the progress payments method, which might provide funds for operations, would also generate taxable income and create a further claim on cash flow.

The costs of this increased borrowing caused by the reduced cash flow would be reflected in increased contract prices. And this comes at a time when we are starting to come to grips with inflation. On analysis, it would seen to be counter productive to change long-standing tax laws in a manner that can only be described as inflationary.

B. Increased recordkeeping burden

Another hardship that the progress payment method would create is the necessity to maintain two different set of records. At the present time, under the completed contract method, the differences between financial and tax income are recognized by relatively simple adjustments to the financial books. However, as a result of the Administration's proposals, the presently available straight forward reconciliation would no longer be practical, in many cases, under the progress payment method. The construction contractor may have to maintain two or more independent sets of records: financial and tax.

A principal reason for this increase in internal bookkeeping requirements in the new cost allocations proposed for use with the progress payment method. The proposed new rules affect a significant amount of the costs incurred by a contractor. They also are unacceptable for financial statement purposes. For example, research and development costs, advertising costs and executive compensation must all be expensed under financial accounting rules. If the progress payment method is enacted as proposed, these costs, together with the other listed costs, have to be treated independently for tax and financial accounting purposes. The sophistication of the contractor's recordkeeping system now becomes the controlling factor of how much additional time and money must be spent on generating the necessary financial or tax information. These added costs, which will not be insignificant, are particularly unsettling when construction contractors are fighting to remain solvent.

6. CONCLUSION

To now ask an industry that has been operating under tax rules that follow its natural business pattern to suddenly adopt a radically new system hardly furthers the "equitable collection of revenue." You can change the law. But if you do, the construction industry will not be the same.

Most construction contractors are not corporate giants. They do however, represent a solid hard working sector of the American economy. It would be sad to see the industry decimated by this uncalled for change in the tax law. And the ripples that are certain to follow will not help to stimulate our nation's economic recovery.

Thank you for this opportunity to present my views.

MERCURY CO. OF NORWOOD, INC.,
Brockton, Mass., April 20, 1982.

Representative DAN ROSTENKOWSKI,
House Ways and Means Committee,
Washington, D.C.

DEAR REPRESENTATIVE ROSTENKOWSKI: This Company strongly urges the continuance of an unrestricted right by "long-term" contractors to elect the completed contract method of reporting income for Federal Income Tax purposes.

It is our contention that the elimination of this method of accounting would have a devastating impact on "long-term" contractors for the following reasons:

1. Such changes will seriously affect the cash flow of most construction subcontractors. The industry works on an after tax margin of approximately 2 percent. It is not realistic to expect contractors operating at such low margins to absorb the additional costs of money resulting from impaired cash flow. Prices will, of necessity, have to be increased or the contractor will be forced out of business.

2. Based on Mercury's experience in completing hundreds of jobs, we believe that profitability of a job cannot be determined before substantial completion; nor, in many instances, before the job has been completely closed and accepted by the customer.

3. The proposed legislation can cause us to have long term income tax investments in jobs that could eventually lose money. These tax payments on uncompleted contracts; (a) cost us money, further reducting our competitiveness, (b) would appear to be unfair, and (c) are inconsistent with tax treatment of other industries.

4. Our industry overhead costs are similar in nature to general and administrative costs incurred by manufacturing, retailing, wholesaling, etc., organizations. For tax and accounting purposes, these organizations do not generally consider such costs as part of their inventory (inventories of these organizations are counterpart to a contractor's work in progress) and accordingly, if contractors are forced to capitalize general and administrative costs, it would be inconsistent with the treatment allowed to other businesses.

In addition, the inclusion of "interest paid" in work in progress would, from a taxation point of view, place the contracting business at a disadvantage to, and be inconsistent with, tax treatment allowed other industries. Not all interest expense relates to operations. It may relate to acquisitions, non-job-related assets or expenses, e.g. head office buildings, advertising campaigns, etc. to allocate such costs to jobs would, at best, be an arbitarary, time-consuming and largely inaccurate procedure and would also result in IRS Audit difficulties.

Allocation of indirect costs would generate a short-term improvement in the Treasury's cash flow, but on a long term basis it will have no positive effect.

5. Because of profit uncertainty, the calculation of earnings by the percentage of completion method is a subjective process, not readily ascertainable by even the most careful accountants, and results in continuing difference of opinion, dispute and litigation between the IRS and the taxpayer.

The tax law, as it applies to construction contractors, should no be based in the uncertainties of estimating "costs to complete" for jobs in progress. It may be assumed that taxpayers will be overly conservative in using this method of accounting for tax purposes.

The tax code is replete with income deferring devices, e.g. intangible drilling and development costs, accelerated depreciation, installment sales method. It is discriminating to single out one segment of industry and disturb a long established approach to taxation in order to create short-term cash flow benefit for the Treasury.

6. The proposed progress payment is inequitable. While legislation provides for the excess of billings over cost on any job in progress to be included in taxable income, it does not under normal circumstances appear to provide for the deduction from taxable income of the excess costs over billing situations which are common occurrences:

a. They are often related to such matters as material buyouts, and costs associated with items yet to be approved by customers and not yet billed.

b. Also, many projects are low profit margin jobs, and it is only at the time that our retention is billed (i.e. at the end of a job) that our billings finally exceed costs.

The fact that there is no provision for tax relief in the legislation for situations such as a. and b. above would seem unfair. We will continue to be faced with financ-

ing charges relating to these situations in addition to those necessary to pay interest on funds borrowed to pay the increased income taxes outlined above.

7. With reference to the progress payment method of accounting it appears that an assumption is being made that the "right to receive" is easily defined by the terms of each contract. In reality this is not the case. Monthly progress payments are subject to negotiation and adjustment. The subcontractor does not know what the "right to receive" is until the general contractor has processed the payment request and forwarded the check—which is often 30 to 60 days following the billing. Obviously, subcontractors bill for the maximum they feel they have a right to receive. On the other hand, the general contractor and owner will attempt to pay a lesser amount. Given this situation, it will be difficult to determine, and audit, the "right to receive" at the end of the tax year.

8. It may be assumed that financial statements issued by taxpayers for public purposes only, using the percentage of completion method, are prepared with a good deal of optimism in order to present the best picture for purposes of bonding, credit, etc. When used for tax purposes, it should be expected that proper reserves would then be introduced to provide for such contingencies as back charges, claims by the owner or general contractor, non-reimbursable completion costs, together with other reserves or deductions, perhaps proper, perhaps disputable. Such deductions would not be made and would not become the subject of a tax dispute if the return has been prepared on the completed contract method.

9. Because of the negative effects on earnings, we also believe that the proposed legislation will have an adverse effect on the construction industry's ability to raise new funds from the investing public. Because of the nature of our business, it has not been one that has traditionally attracted investor confidence. Earnings multiples on construction industry stocks have often been on the low end of the scale—irrespective of general stock market conditions. This proposed legislation may do further damage to our collective positions by weakening future earnings prospects.

In summery, we urge the continuance of an unrestricted right by long-term construction contractors to elect the completed contract method of reporting income tax for all long-term contracts. To do otherwise would substitute an uncertain litigious method for the clear and comparatively simple completed contract method; would interfere with the ability of surety companies, financial institutions and creditors to determine the financial status of the contractor by removing the only clear and positive form of financial statement; would not increase overall revenue to the government from the construction industry; and to the extent that additional borrowings for taxes would be required of many contractors, with corresponding reduction of taxes by other more conservative taxpayers, would be inflationary.

Very truly yours,

ROBERT S. CAPPADONA, *Treasurer.*

STATEMENT OF PETER SHAPIRO, COUNTY EXECUTIVE, ESSEX COUNTY, N.J., ON BEHALF OF THE NATIONAL ASSOCIATION OF COUNTIES

SUMMARY

This statement addresses two tax revision proposals by the Administration: one to restrict the issuance of private purpose industrial revenue bonds (IRBs) by state and local governments and one to include interest on indebtedness to purchase or carry tax-exempt securities in the calculation of a minimum tax on banking institutions.

Current NACo policy which addresses only small-issue IRBs, supports some limitations at the federal level of their use, including the proposed requirements that (1) all small-issue IRBs must be approved by the highest elected official or elected governing body of the jurisdiction in which the bonds are issued and (2) small issues should be reported in order to measure their exact volume. The policy also endorses elimination of retail commercial and recreational uses of small-issue IRBs in all but economically distressed areas and an equal employment opportunity commitment by users or small-issue IRBs.

NACo policy opposes the following IRB restrictions proposed by the Administration:

(1) requirement that users of small-issue IRBs forego use of the accelerated cost recovery system,

(2) requirement of a 1 percent financial contribution by issuing jurisdictions,

(3) limitation of IRB use to small businesses, and

(4) more stringent arbitrage provisions.

With regard to the inclusion of interest on indebtedness to purchase or carry tax-exempt securities in the calculation of a minimum tax on banking institutions,

NACo opposes this proposal because it would significantly reduce commercial bank demands for state and local obligations and exert upward pressure on the interest rates of these obligations.

STATEMENT

Good morning. I am Peter Shapiro, county executive of Essex County, New Jersey, and vice-chairman of the Taxation and Finance Steering Committee of the National Association of Counties (NACo).[1] I am submitting this statement on behalf of NACo, the only national organization that represents county government.

My statement will be directed toward two tax revision proposals by the administration: the first, to restrict the issuance of private purpose industrial revenue bonds by state and local governments, and the second, to include interest on indebtedness to purchase or carry tax-exempt securities in the calculation of a minimum tax on banking institutions.

Let me first address the issue of the proposed restrictions on industrial revenue bonds, an issue so vital to county governments that NACo President Richard Conder recently appointed a special task force to consider it and reformulate NACo policy in a responsive way. I was co-chairman of that task force and it was very difficult for task force members, who represented a wide variety of county governments, to reach a consensus concerning appropriate restrictions on IRBs. In the end, they supported restrictions only for small-issue industrial revenue bonds, since they felt that continued, unchecked growth in that area potentially posed serious problems.

The resoulution adopted by the task force and ultimately by NACo as an organization emphasizes the important role that small-issue IRBs have played in the stimulation of local capital investment and job creation. But it also acknowledges that, in some instances, abuses have occurred and IRB financing has been of questionable value to economic development. In addition, the dramatic growth in the volume of these bonds from $1.3 billion in 1975 to over $10 billion in 1981 has adversely affected the minicipal bond market by crowding out traditional public purpose bond issues and increasing the interest costs of jurisdictions issuing bonds.

Current NACo policy, therefore, supports some limitations at the Federal level on the use of small-issue industrial revenue bonds only. Specifically, we agree with the proposed requirement that all small-issue IRBs must be publicly approved by the highest elected official or elected governing body of the jurisdiction in which the bonds are being issued following a public hearing. We also agree that small issues should be reported, in order to determine their exact volume. Two other restrictions that we endorse have not been proposed by the Treasury, namely, that retail commercial and recreational uses of small-issue industrial revenue bonds be eliminated for all but economically distressed areas, as determined locally, and that an issuing authority require the agreement by users of small-issue IRBs to an equal employment opportunity commitment based on locally established guidelines. We feel that the imposition of these limitations would correct the abuses of small-issue IRBs that have occurred, would guarantee that small-issue IRBs serve the public purposes of stimulation of capital formation and job development, but would not so drastically curtail the volume of these issues as to render them an ineffective tool for economic development.

While we support some of the restrictions on small-issue IRBs proposed by the Treasury, we do not support others. First, we do not support the proposed requirement that users of small-issue industrial revenue bonds forego the use of the accelerated cost recovery system under the 1981 Economic Recovery Tax Act. We feel that this restriction would drastically curtail the use of small-issue IRBs by private concerns. A recent analysis by Hawkins, Delafield and Wood, a law firm with extensive municipal bond experience, indicates that IRB financing of equipment would be virtually eliminated by requiring users to choose between IRBs and the accelerated cost recovery system. This is because of the clear advantage to be gained through a combination of the rapid writeoffs for equipment, the investment tax credit and salability of tax benefits under the new tax law.

With regard to real property, the analysis compares the present value costs of a representative project when financed by IRBs and when financed by conventional methods and depreciated under ACRS. It concludes that few companies would select

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[1] The National Association of Counties is the only national organization representing county government in the United States. Its membership spans the spectrum of urban, suburban, and rural counties which have joined together for the common purpose of strengthening county government to meet the needs of all Americans. By virtue of a county's membership, all its elected and appointed officials become participants in an organization dedicated to the following goals: improving county governments; serving as the national spokesman for county governments; acting as a liaison between the nation's counties and other levels of government; and achieving public understanding of the role of counties in the federal system.

IRB financing. Only if the differential between tax-exempt and taxable interest rates reaches 7 percent, or if the borrower is in the lower Federal corporate tax brackets, is an election of IRBs likely to be made. Given that the rate differential is not now near the 7 percent level and that most IRB borrowers are in the highest Federal corporate tax bracket, the analysis indicates that the proposed Teasury restriction would substantially curtail the use of IRBs. Such a severe curtailment would destroy the ability of State and local governments to use IRBs as an economic incentive to attract industry. Jurisdictions that are economically distressed, such as my own county of Essex, New Jersey, would be especially disadvantaged by this development.

The second proposed Treasury restriction that we oppose is the requirement that after December 31, 1985, a governmental unit issuing IRBs must make a financial contribution to the project equal to 1 percent of the face amount of the bond. Although we believe the Treasury Department attempted to grant State and local governments some flexibility in determining the form such a contribution could take, virtually any one of those mentioned in the proposal would present significant difficulties, legal and otherwise, to State and local issuers. For example, the Treasury proposal states that the 1 percent requirement could be met if the bonds issued were general obligation bonds or were guaranteed by the jurisdiction. Over thirty States currently impose constitutional debt limits on their localities. In order to accommodate the proposed Treasury requirement, either these State constitutions would have to be amended—a long process that most likely could not be completed by 1983 in many States—or local issuers wishing to issue general obligation bonds for industrial development would have to forego issuance of general obligation bonds for traditional public purposes. It is unlikely that many jurisdictions would elect to do this, especially since the credit rating for their general obligation bonds might suffer as a result of financing a private concern. Similar problems exist with virtually all the other possible forms of financial contribution, and it is our feeling that this is an onerous requirement and that would severely restrict the ability of jurisdictions to issue IRBs. Furthermore, we feel that if the purpose of the requirement is to ensure that industrial revenue bond issues serve a legitimate public purpose, then it is perhaps redundant and unnecessary. This objective would be realized through the proposal requirement of approval of a bond issue by the highest elected official or governing body of the jurisdiction in which the bonds are being issued. Any additional requirement to accomplish the same goal, especially one as potentially unworkable as this, would be overkill in our opinion.

A third proposed Treasury restriction that NACo opposes is the limitation of the use of small-issue IRBs to small businesses, defined as those with capital expenditures of less than $20 million during the period from three years before through three years after the issuance of the bonds. We support continuation of the existing capital expenditure requirements because there are instances when the issuance of IRBs to finance a project of a large corporation can be very beneficial to economic development within a jurisdiction, especially if the jurisdiction is economically distressed. To modify the existing capital expenditure requirements in such a way as to limit all IRB use by large corporations would destroy the flexibility now present within the system to accommodate cases where such use can be positive and valuable. Again, the proposed requirement that bond issues be approved by the highest elected official or governing body of a jurisdiction would suffice to prevent most use of IRBs by large corporations when such use was deemed unsuitable or unnecessary because of the availability of private financing or for some other reason. According to this same rationale, we also oppose the limitation on corporations of $10 million of outstanding IRBs proposed by the Treasury.

Finally, we oppose the Treasury proposal to extend restrictions on the investment yield from the use of the proceeds of industrial revenue bonds to reserve funds and funds held during the temporary construction period. This proposed restriction would appear to reflect the opinion of Treasury that some jurisdictions are, in a sense, "profiting" from the issuance of small-issue industrial revenue bonds by investing bond proceeds in higher yielding securities. From the perspective of issuing jurisdictions, however, such investments simply represent prudent cash management. In most cases, investment proceeds are used to reduce the cost of the bond issue and as a hedge against unforeseen increases in construction costs due to inflation.

That summarizes NACo's responses to the Treasury proposals concerning the restriction of industrial revenue bonds. Before leaving this subject, however, I want to raise one issue—that of the revenue loss to the Federal Treasury represented by these bonds. The Congressional Budget Office estimated in a study last year that the loss to the Treasury represented by small-issue industrial revenue bonds would be

$1.4 billion in 1982, given a 10 percent rate of growth in the volume of these bonds. The size of this revenue loss, in a time of burgeoning Federal deficits, has been one factor that has prompted the proposed restrictions. It should be pointed out, however, that accurate estimation of revenue loss from small-issue IRBs is not easily done, since it is not certain that all projects financed by industrial revenue bonds would be financed by taxable loans if IRBs were unavailable and because the increased economic activity generated by these bonds and the additional taxes produced by that activity partially offset any revenue loss. A 1980 study by Norman Ture, currently Undersecretary of the Treasury for Tax and Economic Affairs, concludes, in fact, that if the $10 million size limit on small issues were increased to $20 million, it would produce a net increase in Federal revenues through increased economic activity. Because of the difficulty in determining the loss, if any, to the Treasury represented by small-issue industrial revenue bonds and the questionable assumption that this loss should be recouped by restricting what many State and local governments consider to be a legitimate use of their tax-exempt authority, the development of NACo's policy concerning small-issue IRBs has been structured to deal with what we perceive to be the negative effects of these bonds on our own jurisdictions, rather than on the Federal Government.

Now I would like to address briefly the administration's proposals concerning the minimum tax on corporations; specifically, the proposal to include interest on indebtedness to purchase or carry tax-exempt securities in the calculation of a minimum tax on banking institutions. The National Association of Counties opposes this proposal on the grounds that it would have an adverse impact on the municipal bond market. It would significantly reduce the demand for State and local obligations of commercial banks, currently the largest institutional holders of municipal securities, with holdings of $155 billion.

The reduction in demand for municipal securities that would result from this proposal follows hard on the Economic Recovery Tax Act of 1981, which has already reduced the attractiveness of municipal bonds to investors by reducing the latter's taxable income through a battery of measures, including a decrease in the top marginal personal tax rate; a general reduction in the personal tax rate; the accelerated cost recovery system; the all savers certificates; changes in leasing provisions; liberalization of individual retirement accounts; and changes in estate taxation. These measures have increased competition for investment and exerted upward pressure on interest rates of municipal securities. State and local governments are finding it more difficult than ever to finance public purpose projects in a bond market that is characterized by record high interest rates and a decreasing yield differential between taxable and non-taxable securities. At the same time, these jurisdictions are bearing the brunt of reductions in Federal spending and the realignment of functional and funding responsibilities necessitated by the New Federalism. They are struggling gamely to continue to deliver services to citizens and maintain their capital infrastructure, but their task will not be made easier by this Treasury proposal.

A recent study by the Municipal Finance Officers Association estimates that inclusion of debt interest deductions in the minimum tax base will reduce bank demand for tax-exempt securities by 20 to 30 percent of their current holdings. Surplus current holdings produced by this decreased demand would exert upward pressure on interest rates of municipal securities of between eight-tenths of one percent to two percent, according to the MFOA study. These increased interest rates would further narrow the differential between taxable and non-taxable securities and consequently render municipal securities less valuable to governments as a financing mechanism.

Because of its probable adverse impact on the municipal bond market, the National Association of Counties urges that this provision be eliminated from the minimum tax proposal.

STATEMENT OF FRED J. NAPOLITANO, NATIONAL ASSOCIATION OF HOME BUILDERS

SUMMARY

State of the housing industry

1981 was the housing industry's worst production year since 1946. 1982 could be worse.

This continued decline is caused by high interest rates and federal deficits.

NAHB supports improvements in the Administration's revenue collection system but has reservations regarding some specifics of the Administration's plan, namely the following:

Corporate minimum tax

NAHB opposes the inclusion of accelerated depreciation of real property as a tax preference item in relation to the corporate minimum tax.

NAHB opposes inclusion of a portion of current deductions of certain indirect costs incurred with respect to long-term contracts entered into on or before February 26, 1982, as a tax preference item subject to the new corporate minimum tax.

NAHB opposes the disallowance of deductions for net operating loss carryovers and carrybacks in computing the corporate minimum tax base.

Completed contract accounting

NAHB opposes repeal of the completed contract method of accounting and removal of the contractors choice of the cash or accrual methods of accounting.

NAHB opposes the proposed alternatives in the treatment of certain currently non-allocable, indirect expenses, by allocating them to long-term contracts. Such costs include pension costs, interest, officer compensation, and general and administrative expenses.

Construction period interest and taxes

NAHB opposes amendment of Section 189 to require that corporations capitalize interest and taxes incurred in the construction of non-residential buildings over a 10 year period. NAHB favors repeal of Section 189.

Tax exempt revenue bonds

NAHB opposes Administration recommendations to limit the use of tax exempt revenue bonds for multifamily housing financing.

Withholding on dividends and interest

NAHB opposes a five percent withholding tax on interest and dividend payments

Other tax issues

NAHB supports tax incentives as part of any "enterprise zone" plan, with inclusion of a housing component.

NAHB supports the creation of Individual Housing Accounts or penalty free withdrawals from IRAs for housing down payments for first-time homebuyers.

NAHB supports the homeowner mortgage interest deduction as the cornerstone of this nation's commitment to homeownership.

STATEMENT

Mr. Chairman and Members of the Committee: My name is Fred J. Napolitano, and I am a homebuilder from Virginia Beach, Virginia. I am testifying today on behalf of the more than 114,000 members of the National Association of Home Builders (NAHB). Mr. Chairman, since November of 1981, NAHB has suffered a loss of over 9,000 members. NAHB is a trade association of the nation's homebuilding industry, of which I am President.

I appreciate the opportunity to present our views on the Administration's tax proposals for 1982. Before I comment on the specifics of these proposals, I would like to outline for the Committee in some detail, the state of the housing industry today.

Housing production

New housing production in 1981 totaled 1.1 million units as against an annual need for new homes that has been estimated conservatively at 1.8 million units throughout the 1980s. Last year was the worst housing production year since 1946.

1982 could finish as the worst post-war production year yet. NAHB's optimistic forecast for this year holds annual production to about 1.17 million. Housing starts in February fell to a seasonally adjusted annual rate of 953,000, down 26 percent from a year earlier, and down more than 50 percent from the two million annual production levels in 1977 and 1978. February was the seventh consecutive month that housing starts were below the one million annual level.

March is the 40th month of recession in housing. The previous record was set during the Eisenhower Administration when the housing recession lasted 27 months.

New home sales

1981 was the worst year for new home sales since the Census Bureau began collecting statistics in 1963. Only 436,000 new homes were sold, compared to 545,000 homes in 1980 and more than 800,000 in 1977 and 1978.

Since March 1981, annual new home sales rates have been under the 500,000 level. In February this year, the annual sales rate of new homes was 336,000, the second worst sales rate on record.

Actual sales in February nationwide were 26,000 new homes—roughly the monthly number of new homes that were sold in the West alone during 1978 and 1979. In all of the Western states, only 7,000 new homes were actually sold in February. Only 6,000 new homes were sold in the Northeastern and North Central states combined.

Interest rates

Conventional mortgage interest rates now average 17.50 percent. Mortgage rates at such high levels price the vast majority of potential buyers out of the market.

Interest rates normally fall rapidly and decisively during recession, but in this downturn they have declined slowly and have remained in an historically high range. Analysts forecast that mortgage rates are not likely to drop below 15 percent this year, thereby killing off any chances for a housing recovery in 1982. The consesus is that home sales will remain at depresesion levels until mortgage rates drop to the 12 percent range, which by historical standards still represents an extraordinarily high cost of home financing.

By reducing interest rates from 16 percent to 12 percent, 4.6 million additional families could qualify for a $65,000 mortgage. At 12 percent interest rates more than 22 percent of the nation's families have the $35,000 income needed to qualify for a modest $65,000 mortgage. At 16 percent fewer than 14 percent have the $44,000 income needed to qualify for the same mortgage amount.

Unemployment

Unemployment in the construction trades in March was 17.9 percent or 928,000 unemployed workers, accounting for 9.4 percent of the total unemployed work force. Another 200,000 skilled craftsmen could lose their jobs over the next several months.

An estimated 200,000 self-employed people in construction-related businesses have either shut down or sharply curtailed their operations in the housing industry. Self-employed people are not counted in the Labor Department's unemployment statistics.

Bankruptcies are up 33 percent for construction firms and 65 percent for contractors.

Rising joblessness toward levels not experienced since the 1930s continues to feed the federal deficit. The Congressional Budget Office estimates that every one percent increase in unemployment costs the Treasury $25 billion—$19 billion in lost revenue and $6 billion in new expenditures to pay for unemployment programs.

United States v. the world

New housing productin in the United States is outdistanced by almost every industrialized nation and the Soviet Union. Among the major western nations only Great Britain has recently been investing less in its housing stock than the U.S.

In 1946, seven housing units were produced per 1,000 of U.S. population. Last year, the U.S. rate fell to only 4.8 starts per thousand. In the U.S.S.R. last year, housing production was reported at eight units per thousand.

1981 housing production in Japan was higher than in the U.S., even though it has roughly half the population. And they thought they were in the midst of a downturn!

In 1981, private residential investment in 1980 was only 3.6 percent of the nation's Gross National Product, compared to 6.8 percent in France and West Germany, 6.5 percent in Japan, five percent in Italy and 4.8 percent in Canada.

According to the Federal Reserve Board, housing's share of the credit markets has declined from 31 percent in the 1950s and about 25 percent in the 1960s and 1970s to only 16.4 percent in 1980–81. By comparison, the federal government's share has increased from 7.7 percent in the 1950s to almost a third last year.

Mr. Chairman, these statistics show with no uncertainty the critically depressed state of our industry. Unless and until mortgage interest rates are reduced to affordable levels, our industry will not show any signs of recovery. I am sure this Committee is aware that in the past seven recessionary periods, it has been the housing industry that has led the overall economy out of recession.

Reduce Federal deficits

The only long-term solution to bringing down interest rates is by reducing the federal deficit. The prospects of a $100 billion plus deficit for the coming fiscal year is only made worse by out-year deficit projections of $400–500 billion. We support the

Administration's desire to improve the efficiency of its revenue collection system as an element of its program to reduce the deficits. However, there are some elements of the Administration's tax proposals which we believe will hinder the ability of small businesses, such as homebulders, to conduct business. Rather than increasing federal revenues, such proposals may serve to inhibit businesses and possibly reduce revenues.

I. CORPORATE MINIMUM TAX

Under present law, corporations are required to pay an "add-on" minimum tax, so called because it is added to the corporation's regular income tax, equal to 15 percent of certain items of tax preference.

Proposed changes

Effective January 1, 1983, the present add-on corporate minimum tax would be replaced with a new 15 percent "alternative" minimum tax on "adjusted corporate profits" in excess of $50,000. The new tax would be an alternative tax in the sense that corporations would be required to pay it only if it exceeded their regular corporate income tax, in which event they would not pay the latter tax.

"Adjusted corporate profits," the base to which the 15 percent rate would apply, would be calculated by adding back to a corporation's taxable income (excluding net operating loss carryovers or carrybacks) the same tax preference items that are subject to the present minimum tax other than long-term capital gains, in addition to several new preference items.

No credits other than the foreign tax credit would be allowed to offset the new minimum tax. The excess of the minimum tax paid in any year over the regular corporate income tax liability calculated for that year could be carried over for 15 years as a credit against the regular tax.

The problem

Items of tax preference

Among the items of tax preference to be added to taxable income in determining the proposed base for the new minimum tax would be an amount equal to the excess of accelerated depreciation over the amount that would have been allowed had the straight-line method been utilized. This same amount is now an item of tax preference in the computation of the add-on minimum tax.

NAHB has opposed the treatment of this amount as a tax preference item since the enactment of the add-on minimum tax in 1969. Such treatment constitutes a penalty imposed upon businesses that engage in real estate activity. The Administration proposes to continue this penalty under its new alternative minimum tax on corporations.

In the view of NAHB, the continuation of such treatment of accelerated depreciation would be as unwise as it would be unfair. At the present time, the home-building industry is in a more depressed condition than at any time within memory. Under the circumstances, the prudent tax policy would be to encourage the home-building industry rather than to penalize it. This is especially true since it is upon the recovery of the home-building industry as much as any other economic development that a general improvement in the economy will depend.

Accordingly, NAHB urges this Committee to reject the Administration's proposal to include accelerated depreciation of real property among the tax preference items that will be subject to the new alternative minimum tax on corporations. Moreover, if the Committee should decide to retain the present add-on minimum tax, NAHB urges the Committee to vote to terminate the inclusion of such accelerated depreciation as a tax preference item under that tax. We emphasize that in calling for such action, NAHB is not requesting creation of a new tax benefit to favor the home-building industry but merely advocating the removal from the tax code of a discriminatory provision.

Another item that the administration proposes to include as a tax preference item subject to the new minimum tax on corporations is a portion of current deductions of certain indirect costs incurred with respect to long-term contracts entered into on or before February 26, 1982, and reported under the completed-contract method of accounting. As is well known, the completed-contract method of accounting is widely utilized within the home-building industry. The inclusion of such costs among tax preference items subject to the corporate minimum tax will have an adverse effect upon the home-building industry. The same economic conditions that require elimination of accelerated depreciation of real property as a tax preference item also counsel strongly against adoption of these costs as a tax preference item.

Furthermore, even if these adverse economic conditions did not exist, the administration's proposal is highly unfair. Taxpayers who previously entered into long-term contracts undoubtedly relied upon the established tax rules in computing their prospective economic gains from the contracts. One of the factors that will have entered into such computation is the tax liability to which performance of the contracts would give rise. If Congress were now abruptly to increase that liability, as it would do if some of the contract costs were subjected to the proposed minimum tax, the planning of these taxpayers would be substantially frustrated. In the view of NAHB, such disregard of the legitimate economic expectations of taxpayers is unreasonable and inequitable.

Accordingly, NAHB urges this Committee to reject the Administration's proposal to include the previously described costs within the tax preference items subject to the new minimum tax.

Effective disallowance of net operating loss carryforwards.—In computing the corporate minimum tax base, no deduction would be permitted for net operating loss carryovers and carrybacks. Although credits for the minimum tax paid would be permitted, the amount of any NOL carryover or carryback allowable in computing the regular corporate tax would be deemed to be "absorbed * * * even in years in which the corporation pays the corporate minimum tax instead of the regular tax." Effectively, the NOL carryover is denied in computing the minimum tax.

This effect is illustrated by the following example:

Home Construction Corporation had no taxable income during 1981 and 1982, but instead suffered losses of $100,000 in each year. For those years, its regular tax liability is zero and its alternative minimum tax is zero. In 1983 it has $200,000 of income but, because of the NOL carryforward, the regular tax liability for that year is zero. It will still be assessed a $30,000 alternative minimum tax despite having no preference items of income because of the disallowance of the NOL carryforward.

Whatever the theoretical justification of disallowing NOL's in computing the new minimum tax, the disallowance imposes a greater burden on the housing industry than that imposed on most other industries. More than most industries, housing is traditionally cyclical in nature. The ability to utilize NOL carryovers permits homebuilders to have their tax assessed on the basis of their performance during an entire cycle rather than during each of the parts thereof, in which income may fluctuate dramatically. Separating the profitable periods out from the cycle and imposing a minimum tax works manifest injustice to the home-building industry.

II. PROPOSED REPEAL OF THE COMPLETED CONTRACT METHOD OF ACCOUNTING

The completed contract method of accounting is one of two special long-term contract methods permitted under the regulations promulgated pursuant to section 451 of the Internal Revenue Code, the other being the percentage of completion method. In addition, there are presently available to the long-term contractor the usual methods of accrual and cash accounting.

A long-term contract is a building, installation, construction, or manufacturing contract which is not completed in the taxable year in which it commences. Homebuilding contracts generally will be categorizable as long-term contracts. However, manufacturing contracts normally are not considered long-term contracts unless the manufacture involves unique items, or items which usually take more than twelve months to complete.

Long-term contractors must elect a method of accounting with their initial Federal tax return filed. There is no conformity requirement, however, so that the method used for tax purposes may differ from that used for financial reporting purposes.

Present law

The completed contract method of accounting deviates from normal accounting practices in an effort to more clearly reflect the economic experience of the long-term contractors. As opposed to normal annual accounting period concepts, income or loss under the completed contract method is reported on a contract-by-contract basis. The gross contract price is reported as income in the taxable year in which the contract is finally completed and accepted, even though payments are received throughout the course of the contract. In general, deductions for all expenses properly allocable to the contract must be deferred until the income is realized. Present regulations do, however, allow certain indirect costs to be deducted currently.

The regulations permitting the completed contract method were promulgated in 1918. During the intervening sixty years, the construction industry has achieved a high degree of stability and certainty with respect to its tax liability through cash management methods which have essentially eliminated the need for profit esti-

mates. Now the Administration seeks to remove this certainty and impose greater record keeping burdens on the industry through imposition of the percentage of completion or progress payment method because of a desire to achieve a "better matching of income and deductions".

Administration proposal

Legislative proposal.—The legislative proposal (1) would repeal the completed contract method and (2) remove the contractor's choice of the cash or accrual methods of accounting by providing that taxpayers must elect to use either the percentage of completion method or the progress payment method of accounting for long-term contracts. Under the progress payment method, most costs are allocated to long-term contracts and deferred until the taxpayer has a right to receive payment under a contract. At the time the right to payment accrues the taxpayer may deduct the total of the current and previously unclaimed costs allocated to a contract, up to the amount of the accrued payment. If the accrued payments exceed costs, the taxpayer would recognize the excess as income. Certain borrowings in lieu of payment are treated as payments.

Regulatory proposal.—The current regulations regarding accounting for long-term contracts would be amended in two main respects:

First, the regulations would be changed to require that, in the case of contracts accounted for by the completed contract method, all but a limited list of indirect costs will be allocated to long-term contracts and deferred until such contracts are completed. Included in this group of costs which would no longer be deductible by contractors are interest, pension, and general administrative expenses.

Second, the regulations would be amended to clarify when an agreement, or series of agreements, must be regarded as more than one contract.

Why the completed contract method is used

The construction industry is a high-risk, and, at present, a high-failure rate industry. Many of the small firms which comprise the bulk of the building constituency are relatively cash-poor and are subject to extreme competition. These market conditions narrow profit margins to an extent that is inconsistent with the market risks undertaken. In addition, most companies engaged in the construction of structures, whether residential or commercial, are closely-held, so that there is a commensurate need for accurate and comprehensive tax planning in an economy that discourages the generation of operating capital in the credit markets.

Repeal of the completed contract method will subject the long-term contractor to taxation on unrealized, unearned and undetermined profits. By definition, the completed contract method is used only by those taxpayers entering into long-term contracts, i.e., those spanning at least two taxable years. Because of this extended period of performance, the possibility for necessary, substantial modifications is increased, especially in the construction of custom homes or buildings.

Seldom is it possible to determine the economic profit on a contract until its completion, due to the accumulated vagaries of the construction business. The work performed by contractors is usually performed on sites not subject to the complete control of the contractor. Completion of the contract may be delayed by jobsite mishaps, inclement weather, strikes, price increases, bankrupcty of subcontractors or suppliers, latent defects, failure of owners to pay, outstanding claims, litigation and other causes. Also, because every construction job is different, the ability of the homebuilder to enjoy the benefits of "economies of scale" and mass production, available to other industries, is substantially diminished.

In the face of such uncertainty and variety of construction conditions, any method of pricing which relies on estimating costs with the addition of a reasonable profit is inherently inaccurate. In effect, prices are fixed before costs are accurately determined. Even in the case of cost-plus contracts, in which a contractor receives reimbursement for costs incurred plus a reasonable profit, not all costs can be anticipated, and may not be reimbursable under the terms of the contract.

Because it is common for receipts to lag behind expenditures on a particular job, contractors require interim operating funds to maintain the steady progress of work. Often this is accomplished through drawing on receipts from other, concurrent projects, and often through bidding methods which allow certain costs to be "front-loaded" so that sufficient operating capital can be assumed over the life of the project.

If anticipated, and possibly overstated profits, are prematurely subjected to income taxes when received rather than when actually and economically earned, contractors will be forced to augment their cash flow through the use of borrowed funds (if available) in a time of unprecedented interest rates. Additional expense due to interest charges, incurred when the normal "retainage" (withholding of

funds) by the owner typically approximates 10 percent of the contract price (often more than the total anticipated profit of the job), is incongruous when tax on a speculative profit is paid in real dollars. (It should also be recognized that the costs accumulated on a contract, unlike an accumulation of inventory, have little marketability or worth in the absence of application to a specific project. Thus the collateral value of such "assets" in the credit market is minimal.) If, notwithstanding the difficulties in obtaining loans for operating capital, a contractor is able to obtain such funds, the Administration proposes to tax the loan proceeds as income. Not only will this further aggravate the contractor's operating difficulties, but it is a drastic departure from basic principles of Federal income taxation.

It is unreasonable to believe that these increased costs, due to the cost of borrowing, and the added costs incurred and passed on in turn by subcontractors on the job, who will also be precluded from using the completed contract method, will not eventually be paid by the homebuying public. It is submitted that the end result will be cost accelerations greater than the implicit cost to the government of the present tax deferral.

The Administration proposes the destruction of an accounting method that has been expressly authorized for over 60 years. We suggest that given the longevity, stability and appropriateness of the method, the Administration's approach of total repeal cannot be justified.

Administrative changes in treatment of indirect costs

Present law

Under the regulations promulgated pursuant to section 451, all direct costs attributable to the contract, and most indirect costs "incident to and necessary for the performance of particular long-term contracts" must be allocated to the contract; thus deductions for such costs are deferred until the taxable year in which income from the contract is realized.

Expenses that are not attributable to specific contracts, that is, those which benefit the taxpayer's business as a whole, or those which Congress has determined to be of such importance that they should be currently deductible, are not required to be allocable to the contract. The Treasury Department now proposes to drastically alter the treatment of these currently non-allocable, indirect expenses, so that an "all indirect costs that directly benefit the performance of long-term contracts and an appropriate part of all other indirect costs must be allocated to long-term contracts."

In seeking to overthrow the carefully crafted rules relating to the allocation of indirect costs, the Treasury Department is repudiating the results of a careful dialogue between industry and the Department between 1971 and 1976. NAHB believes this effort to be ill-advised, both in terms of administrative complexity and its effect on contractors' ability to deduct ordinary and necessary business expenses vis a vis other industries that do not engage in long-term contracts.

Some of the more important period costs which are proposed to be allocated in some, as yet undetermined manner, include the following:

1. Pension costs.—Under current regulations, pension costs and other indirect costs incurred by a taxpayer in the performance of long-term contracts and construction of capital assets are deductible currently even though the taxpayer is utilizing the completed contract method of accounting. See Treas. Reg. §1.451-3(d)(5). Further, this treatment has been a part of the tax law for at least 42 years. See I.T. 3408, 1940-2 C.B. 178. Representatives of the Internal Revenue Service have on numerous occasions admitted the appropriateness of allowing current deductions for pension costs. See, e.g., *Commissioner* v. *Idaho Power Company*, 418 U.S. 1 (1974). (It should be noted that the Internal Revenue Service has, for approximately four years, had a project to consider the capitalization of certain pension costs as they relate to the construction of capital assets. We understand that project is still undergoing preliminary consideration.)

As part of its proposals, the Administration has suggested that by regulation pension costs should no longer be currently deductible but should be allocated to the long-term contracts with which they are associated. An exception would be provided, however, for past service pension costs. See General and Technical Explanation of Tax Revisions and Improved Collection and Enforcement Proposals at 7 (February 26, 1982). The Administration has also suggested that this new treatment be applicable legislatively to the progress payments method and percentage of completion methods to be adopted by Congress.

The National Association of Home Builders stongly believes that the changes suggested by the Administration with respect to pension costs are entirely inappropriate and should not be adopted either legislatively or regulatorily. Further, we sug-

gest that this committee direct the Internal Revenue Service not to change its regulations until Congress has had an adequate opportunity to fully review this matter. We further suggest that even if the percentage of completion or progress payments method is adopted legislatively, such legislation permit the current deduction of pension costs for the reason we will describe.

The treatment of pension costs suggested by the Administration is inappropriate and arbitrary, and will create substantial complexity. Those who developed the proposal apparently made the assumption that pension costs are like wages and can be readily allocated to specific projects. In fact, pension costs are totally unlike wages in that they cannot reasonably be associated with periods of employment spent on particular projects. Further, the distinction made by the Administration between past service costs and current costs is, in reality, arbitrary. These funding distinctions were developed as a method of spreading costs, not as a means of identifying periods to which the costs relate. As the current regulations recognize, pension costs relate more to the employee's total period of employment. The precise method of funding those costs has little or no bearing on the period to which those costs relate. Further, if such allocations were required, unrealistic distortions and complexity in the handling of pension costs would result. This would be especially true where employees are moved from job to job.

The rules in the Internal Revenue Code regarding pension plans have been carefully developed over many years under a system that assumes costs are deductible currently. For example, employers are allowed deductions within specified limits under section 404(a) of the Internal Revenue Code. The capitalization of pension costs would distort the system for placing limits on both the funding and deduction of pension costs because of the bunching that would result. These distortions would have adverse effects on the entire design of the pension system.

Perhaps the strongest argument against changing the treatment of pension costs for taxpayers utilizing the completed contract method of accounting is that it would undermine the national policy of providing major incentives for the adoption and continuation of pension plans. Providing retirement income to employees is perhaps the strongest incentive endorsed by the Internal Revenue Code. Specific rules have been adopted to ensure that pensions are provided to employees on a nondiscriminatory basis and to strongly encourage employers to adopt pension programs so that employees will receive adequate retirement income. The need to expand pension coverage was strongly endorsed recently by the President's Commission on Pension Policy. See, for example. Coming of Age: Toward a National Retirement Income Policy (February 26, 1981). The Commission also emphasized the need for a uniform national policy encouraging increased coverage of workers. The Administration's proposals on pension costs for taxpayers using the completed contract method of accounting would not only undermine the need for a uniform national policy, they would also directly conflict with the goal of encouraging employers to establish nondiscriminatory plans to provide adequate retirement income for employees.

2. Interest.—Section 163 specifically provides for the deduction of interest. Section 266, in turn, limits the capitalization of carrying charges, such as interest, to specific circumstances at the election of the taxpayer. These Code sections and others illustrate the acknowledgement by Congress of the current deductibility of a charge for the use of money over time.

Despite these legislative precedents, the Treasury Department would allocate interest to particular long-term construction contracts and require it to be capitalized for deferred deduction only upon completion of the contract.

Practically, allocation of interest to long-term contracts presents problems due to the general practice of funding several ongoing projects through incurring debt. The basic problem is choosing a rational allocation system. The possible allocation of interest on the amount of billings per project for the taxable year, for example, ignores the wide flexibility in the industry reflected in advance payments, mobilization payments, and front-loaded contracts.

The regulations under Section 861, designed to deal with a similar problem—the allocation of interest expenses between foreign and domestic income—state that the interest deduction should be most accurately apportioned on the basis of asset values. The feasibility of transferring a like standard to long-term contracts is not at all assured. Costs in excess of billings, i.e., assets values, are recorded, but are poor reflections of actual income producing capacity. If these complex and inappropriate rules are not adopted, the Treasury may fall back on an allocation system grounded on "estimates" of income, precisely the uncertainty that the completed contract method is designed to avoid.

3. Officer compensation.—Under current regulations, when management level personnel directly perform services attributable to specific projects, allocable expenses

are capitalized. The more difficult situation, at least administratively, is raised by the Treasury's attempts to allocate officers' ompensation attributable to time and effort devoted to activities which unquestionably benefit the company, but cannot legitimately be claimed to correspond to any one project.

For example, long-term corporate planning is undertaken for the benefit of the entire company, not for a particular job, and not necessarily for a particular taxable year. We submit that any proposed allocation method in this area would be arbitrary and therefore administratively burdensome.

4. General and administrative expenses.—These expenses conceptually do not contribute to the completion of particular contracts, but benefit the performance of the enterprise through maintenance of the capabilities to pursue such contracts successfully. They represent, in effect, the costs that must be paid by every business, whether involved in the long-term contract or simple service-oriented businesses. Administrative costs—overhead—which can be allocated, already are capitalized under the existing regulations. To require more would penalize businesses engaged in long-term contracting by denying them current deductions enjoyed by their counterparts in industry.

III. DEDUCTION OF CONSTRUCTION PERIOD INTEREST AND TAXES

Present law

Subject to certain exceptions, amounts paid or accrued as interest and taxes in connection with the construction of real property held for business or investment purposes must be capitalized and amortized ratably over specified periods, as set forth in Section 189 of the Internal Revenue Code. Exceptions to this rule include 1) amounts paid or accrued in connection with the construction of low-income housing, and 2) a general exclusion for corporations; that is, corporations that construct real estate may currently deduct the interest and tax costs as they are incurred prior to the time the property is placed in service or offered for sale.

Administration proposal

The Administration, in its General and Technical Explanation of Tax Revisions, includes a proposal to amend section 189 to require that corporations capitalize interest and taxes incurred in the construction of non-residential buildings, and recover them ratably over a 10-year period. Thus, one-tenth of the interest and taxes incurred during a construction year may be deducted in that year; the remaining nine-tenths would be deducted ratably in each of the nine years beginning with the taxable year in which the building is ready to be placed in service.

The position of the National Association of Home Builders, as has been consistently maintained, is that section 189 should be repealed in its entirety, and that construction period interest and taxes should be currently deductible. NAHB supported the provision exempting permanently from the application of Section 189, construction period interest and taxes paid or accrued with respect to low-income housing for taxable years beginning after December 31, 1981, as included in the Economic Recovery Tax Act of 1981.

In the face of this moderating provision, the Administration has now proposed to restrict the ability of corporate taxpayers to currently claim deductions for taxes and interest incurred during the construction period.

Taxes are a recurrent expense; tax bills recur yearly, and are paid as they are issued. In other businesses, a deduction is allowed for taxes in the year in which they are paid. The same is true for construction period interest payments. Construction interest is attributable to a construction loan that exists only during the twelve to twenty-four month period when a multifamily housing project is under construction. When construction is complete, the construction loan is paid off, a new permanent take-out loan is issued and a new, recurring interest charge begins. The real estate industry is discriminated against by not being allowed the deduction in the year in which construction period tax payments are made.

We can see no justification for capitalizing construction period interest and taxes. These items are akin to current expenses. The provisions of the Code prior to their amendment in 1976 provided incentives necessary to attract investment to an industry already suffering a shortage of capital. So long as there is no attempt to avoid legitimate taxes by prepaying interest attributable to other periods, interest and tax deductions should be allowed in the year in which payments are made.

We are concerned by the statement in the General and Technical Explanation that "there is no economic policy or tax administration reason why corporations should not be subject to the same rule as individual taxpayers in [regard to section 189.]" This assertion denies the very legislative basis on which the Congress amend-

ed section 189 in 1976 to preclude abusive tax shelter schemes. Before then real estate ventures were formed to allow a pass-through of tax benefits sufficient to draw needed capital to an important industry. Congress felt that in some cases these benefits were too rich and foreclosed the ability of individuals, partnerships, and subchapter S corporations to currently deduct construction period interest and taxes. They specifically acknowledged, however, the lack of abuse in the corporate area, primarily because of the inability to pass-through benefits to individuals, but also because of a realization that benefits stimulating housing construction are essential. We submit that the Treasury Department errs in its current analysis of the economic policy justification of section 189.

Furthermore, the Treasury Department alludes to possible clauses in section 189 through attempts to evade the proposed elimination of the completed contract method of accounting. As we have stated, these changes are unwarranted. They should not be adopted; nor should restrictions in section 189 be the medium through which such fractious revisions are promulgated.

While we appreciate the exclusion by the Administration from the revised proposal of residential real property, we urge this Committee to scrutinize carefully the rationale behind the Administration's limited proposal. After careful evaluation we believe this Committee will recognize that the Administration's proposal, and indeed section 189 itself, are not justified.

IV. TAX EXEMPT REVENUE BONDS

Present law

The Mortgage Subsidy Bond Tax Act of 1980 was enacted generally to direct the subsidy from the use of tax-exempt bonds for housing to those individuals who have the greatest need for the subsidy, to increase the efficiency of the subsidy, and to reduce the overall revenue loss to the Federal Government from the use of tax-exempt bonds for housing.

Industrial development bonds for multi-family rental projects

Definition of "low or moderate income."—Tax-exempt industrial development bonds may be used for multi-family rental projects only if 20 percent of the units (15 percent in targeted areas) are occupied by individuals of "low or moderate income", as defined in section 8 of the United States Housing Act of 1937.

Duration of targeted requirement.—The 20-percent requirement (15 percent in targeted areas) must be met for 20 years with respect to any obligations issued before January 1, 1984.

Administration proposal

The Administration's proposal to restrict industrial development bonds has four major provisions that threaten the viability of revenue bonds as a source of alternative multifamily housing financing.

The use of accelerated depreciation is eliminated when tax-exempt bonds are used to finance rental housing developments.

Issuers will no longer be allowed to earn arbitrage on bond proceeds invested during the temporary construction period and reserve funds. Bond issuance costs may not be taken into account in determining the yield for the purposes of the arbitrage limitation.

After 1985, the governmental unit must make a contribution to the facility financed with tax-exempt bonds equal to one percent of the face amount of the bonds.

Bond issues are subject to public review and approval by the highest elected official or legislative body.

Clearly, the most damaging proposal is the elimination of depreciation benefits provided by the Accelerated Cost Recovery System. In the absence of accelerated depreciation, there will be a substantially reduced inducement for investors to place their capital in low and moderate rental housing. The use of accelerated depreciation is necessary to offset the high risks associated with investing in rental housing production.

The Administration recommends the elimination of the unlimited yields issuers currently earn on proceeds during the temporary construction periods and on reserve funds. These positive earnings on reserve funds and funds held during construction have been used solely for the benefit of developments, such as to cover mortgage arrearages, and do not flow to the issuer. Rather, they act as a vital insurance fund providing security to bondholders.

Interest rates on bonds can be expected to increase as a result of inadequate security. The net effect, therefore, may be in increase in mortgage rates. According to a recent study of the 1980 Mortgage Bond Subsidy Act, the Congressional Budget

Office concludes that interest rates, and subsequently, mortgage rates, may have been adversely affected by tight yield restrictions. A similar negative impact on multifamily mortgages can develop if the Administration's yield provisions are adopted.

Even with investment earnings, issuers have had to contribute their own administrative funds to cover debt service payments. This will be further exacerbated by the Administration's proposal requiring a contribution equal to one percent of the face amount of the bonds after 1985. Since states and localities are undertaking substantial risks in financing low and moderate income households, it is unconscionable to require this additional contribution, particularly for less affluent states and localities.

Finally, the public review requirement will add yet another regulatory burden to the issuance of rental housing bonds. This requirement is directly contradictory to the Administration's position on deregulation, which we generally support.

Thus, the National Association of Home Builders adamantly opposes the Administration's proposed restrictions on the use of tax-exempt multifamily mortgage revenue bonds. The Administration has also recently proposed the elimination of federal subsidies for new construction to provide housing for low and moderate income households, although an estimated 400,000 starts in multifamily units are needed each year throughout the 1980's. given this projected need, effective vacancy rates of less than two percent and unprecedented high unemployment in the construction industry, the continuation of a workable mortgage revenue bond program is essential to provide adequate housing for tenants who will otherwise not be served by the marketplace.

The Administration argues that "the volume of tax-exempt bonds for non-governmental users has grown rapidly during the past five years." This does not apply, however, to multifamily reserve bonds. In 1978, $5.6 billion in multifamily bonds were issued, whereas this figure declined to $4.1 billion in 1980, and $3.7 billion in 1981. Furthermore, the issuance of multifamily bonds is small in comparison to other industrial development bonds. Small issue IDBs grew from $1.4 billion to $10.5 billion from 1976 to 1981. Simultaneously, the growth in volume of multifamily reserve bonds was 50 percent, much of which can be attributed to the government's heavy reliance on bond financing to support the Section 8 program. The usage of tax-exempt multifamily bonds has declined in accordance with reductions in Section 8 commitments. Thus, in absence of the Section 8 program. The usage of tax-exempt multifamily bonds has declined in accordance with reductions in Section 8 program, or a similar federal production program supported by tax-exempt bonds, it is anticipated that the annual bond volume will not exceed $1 billion given market constrictions.

As part of the Mortgage Subsidy Bond Tax Act of 1980, Congress agreed to restrictions on the usage of tax-exempt multifamily revenue bonds, specifying that 20 percent of the units in a multifamily development financed with these bonds must be preserved for low income persons, and that all rental housing bonds issued after January 1, 1982 must be preserved for low income persons, and that all rental housing bonds issued after January 1, 1982 must be in registered form. Following two years of debate on this issue, Congress concluded that multifamily bond issuance is not only costly and risky, but serves the public interest. Congress, therefore, exempted multifamily bonds from the strict restrictions imposed on single-family issuance, as well as the 1984 sunset.

The Administration is now suggesting the imposition of severe restrictions on multifamily bonds, although Treasury has yet to release regulations pertaining to the multifamily section of the 1980 law. Perhaps more perplexing, however, is the recent release of these restrictions when, in fact, the Administration is now focusing on liberalizing current restrictions on single family bonds to make the program workable. The public interest of our nation will unquestionably not be served by again imposing restrictions on the issuance of housing bonds, which, in effect, will terminate this program.

In light of the need for substantial expansion of the nation's rental housing supply, NAHB contends that it is unwise at this time to approve these provisions which will essentially eliminate the only financing mechanism available to support low and moderate income rental housing.

WITHHOLDING ON DIVIDENDS AND INTEREST

Mr. Chairman, NAHB opposes the Administration's proposal of a five percent withholding tax on interest and dividend payments made by individuals, partnerships, trusts and estates. We believe this proposal would be difficult to put into

effect and the potential added revenue wold not justify the additional costs of withholding. We urge the Committee to reject this proposal and to explore alternative methods of improving current information reporting requirements.

OTHER TAX ISSUES

NAHB supports the Administration's commitment to creating incentives for revitalization of economically depressed areas through "enterprise zones." While the Administration has not yet fully released the details of its program, we agree that tax incentives are a necessary component. We would also urge the Administration and the Congress to reccgnize housing as a priority in any enterprise zone proposal through a housing component.

INDIVIDUAL HOUSING ACCOUNTS

A major obstacle facing many potential homebuyers today is the inability to accumulate the savings necessary for a down payment. This is especially true for young families and first-time homebuyers. While individual retirement accounts provide a source of long-term savings, they do not take into account the needs of many families who do not have access to their savings before retirement, without paying a penalty. Individual Housing Accounts, such as H.R. 178 intoduced last year by Rep. Conable, would provide a workable savings incentive for housing down payments for first-time homebuyers. NAHB supports this concept, as well as a tax-free withdrawal from an existing IRA for the purchase of a first home as a principal residence.

MORTGAGE INTEREST DEDUCTION

Mr. Chairman, we cannot overstate the importance of the homebuyers mortgage interest deduction. This has been the cornerstone of the nation's commitment to homeownership since 1913 and your support and that of this committee is essential to continue that commitment.

We appreciate the Chairman's and this Committee's interest in housing and we hope to work closely with you this year on issues affecting our industry. I thank you for this opportunity to present our views on this important subject.

STATEMENT OF HERBERT W. GRAY, VICE CHAIRMAN, NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS

Summary of savings bank industry views

In considering the Administration's revenue proposals, a basic concern must be to reduce the federal budget deficit. More than anything else, it is the prospect of chronic, massive deficit financing which is keeping interest rates at intolerably high levels. Prolonged high interest rates, in turn, have created a crisis in the nation's thrift and housing industries and threaten financial conditions not seen since the 1930s. Immediate action must be taken to reduce prospective budgetary deficits.

The balance of our statement will consider those revenue proposals which directly affect our industry and to certain alternatives to these proposals. We believe that our recommendations are consistent with the need to reduce the budgetary deficit. Thus, tax incentives to stimulate saving will encourage capital formation in this nation and ultimately strengthen the economy and federal tax revenues.

Other proposals outlined in our statement, we believe, also have no adverse budgetary implications when all relevant factors are taken into account. They reflect long-standing proposals of our industry to correct inequities or other deficiencies in tax provisions affecting thrift institutions. To the extent that they relieve current devastating pressures on our industry, they will avert the far larger federal expenditures which will inevitably result from regulatory action dealing with troubled thrift institutions.

Withholding of taxes on dividend and interest payments

The savings bank industry strongly opposes the Administration's proposal to subject the payment of interest to withholding. We believe that withholding is not the appropriate method of dealing with any problems of underreporting of interest and is a method which is particularly inappropriate when the increased burdens on financial institutions and depositors are weighed against any improvemnet which may result in the collection of tax on interest income.

Savngs banks recognize their obligation to assist the federal government in the collection of taxes due on interest received by taxpayers. We have always supported realistic and reasonable steps to collect these taxes. Accordingly, we believe that proper administration of the existing regulations requiring financial institutions to

report to IRS the amount of interest paid or credited is the appropriate method of insuring compliance with the revenue laws. Full use of information returns is, we believe, an effective answer to the problem of underreporting. Furthermore, it would be less costly to the public than withholding if all costs and benefits were properly taken into account.

It is ironic that the withholding proposal comes at a time when thrift institutions are experiencing unprecedented strains and the housing industry is experiencing the most serious recession since the end of World War II. Imposition of withholding could aggravate deposit outflows at thrift institutions as depositors shift to tax-sheltered investments. Since it must be assumed that many savings bank depositors pay their taxes, at least in part, from current income, withholding would have the effect of requiring taxes to be paid out of savings. As a result, deposit growth would be further reduced at thrift institutions, in turn, further restricting the availability of mortgage credit for housing. Given these economic problems, we believe that information return reporting, supported by the increased use of automatic data processing and appropriate publicity, is the most effective method of insuring increased compliance. The majority of taxpayers report interest income honestly and accurately. With respect to the minority who do not report accurately and truthfully, strict enforcement efforts should be consistently applied.

We have been encouraged by recent news reports which indicate that the Administration is reconsidering its position on the matter of withholding taxes on interest and dividends. For the record, we stand ready to provide detailed analysis to support our conclusion that an interest withholding system will not solve whatever problems exist in the area of underreporting. Rather, it will create administrative problems for the dispersing banks and additional inconvenience to the depositor, particularly the lower income and retired taxpayers on whom the burden of reporting would most heavily fall. We would reiterate our contention that the utilization of taxpayer account numbers and automatic data processing is the best, most feasible method of insuring that all taxpayers report interest income.

All savers certificate

The savings bank industry has long advocated increased incentives for savings as a means for stimulating investment, controlling inflation, and, as a result, contributing to a reduction of present intolerable budget deficits. In this connection, we would support a permanent extension of the All Savers program, which is currently scheduled to expire at the end of 1982. The Economic Recovery Tax Act of 1981 provided for a lifetime exclusion from income of $1,000 ($2,000 on a joint return) of interest earned on so-called All Savers Certificates. These certificates, which have beeen tied to the investment yield on one-year U.S. Treasury bills, have limited tax exemption and must be issued between October 1, 1981, and the end of the current year. Because of the fact that the exemption from tax on interest earned on these certificates in the amount of $1,000 ($2,000 on a joint return) is a one-time, lifetime exemption, the certificates attracted a tremendous amount of interest when authorized in October, resulting in a substantial influx of funds to financial institutions deposited by individuals who generally limited their deposits to the amounts necessary to earn the maximum exemption. The sharp dropoff in funds attracted to these certificates after they were originally available in October is directly attributable to the fact that the exclusion from income is a one-time, lifetime exemption. On the other hand, the substantial influx of funds resulting from this exemption at the outset is testimony to the fact that extending this program and making the exemption from income of $1,000 ($2,000 on a joint return) available on an annual basis would generate savings. Accordingly, the savings bank industry urges the Committee to consider extending the provisions of the All Savers Act beyond the December 31, 1982, deadline and to broaden the exemption so that it exempts interest earned on an annual basis.

In all events, the savings bank industry urges consideration of permitting the rollover of existing All Savers Certificates at maturity, at least through 1984. In this connection, it should be noted that the $200/$400 interest and dividend exclusion available in 1981 has been repealed, and the new savings incentive provision established by the Economic Recovery Tax Act of 1981, the so-called net interest exclusion, is not effective until 1985. Failure to either extend the All Savers program through 1984, or in the alternative, to permit a rollover of maturing All Savers Certificates through 1984, could have serious implications to the beleaguered thrift industry as these lower-cost funds are replaced by market rate certificates.

Net operating losses and the special thrift bad debt deduction

The savings bank industry would place at the forefront of any tax legislative proposals the resolution of what we feel has been an inequitable interpretation of the law and regulations affecting the taxation of thrifts.

Section 593 of the Internal Revenue Code permits savings banks and other thrift institutions to compute their bad debt deduction through the utilization of a special percentage-of-income deduction which, in general, permits thrift institutions a deduction equal to 40 percent of a specially computed taxable income base. Prior to May of 1978, our institutions were permitted to carry net operating losses back to an earlier year without making an offsetting adjustment to the prior year's bad debt reserve deduction. A 1978 Treasury regulation, which we continue to believe was not supported by the legislative history of Section 593, requires thrift institutions to recompute the special bad debt deduction where a net operating loss is carried back to the earlier year, and provided for prospective application of the regulations.

The practical effect of the 1978 regulations is to substantially reduce any refunds when a net operating loss is carried back to a prior year. The Internal Revenue Service further amended these regulations to provide that if a net operating loss sustained after 1978 is carried back to a year before 1978, the special bad debt deduction for the pre-1978 year must be recomputed—even though the substantive changes in the regulations were made prospective in application effective in 1978. This amendment requires a recomputation of the special bad debt deduction in cases where a net operating loss in 1979 or later is carried back before 1978 and represents a direct modification of the prospective application of the 1978 regulations. What we seek now is not to reopen the question of the validity of the 1978 regulations but rather a phase-in of their applicability so that those regulations will effectively be prospective as originally provided. An amendment to Section 593 of the Internal Revenue Code should make it clear that the carryback of any net operating loss should not require a recomputation in a prior year's tax when that tax accurately reflected the IRS's own interpretation of the tax laws then in effect.

Net operating loss: carryback-carryforward period

The Economic Recovery Tax Act of 1981 (ERTA) extended the net operating loss carryforward period for most corporations from 5 years to 15 years. The carryback provision for corporations others than financial institutions remains at 3 years—effectively a 19-year period over which losses can be deducted. Savings banks and all other financial institutions have been permitted since January 1, 1976, to carry back losses for 10 years and forward for 5 years—effectively a 10-year period over which losses may be accounted. The extensive losses suffered by thrifts from 1979 through the present make it imperative that financial institutions and thrift institutions, in particular, benefit from an increased carryforward period. Indications in our industry are that recent years' losses more than offset any taxable income in the 10-year carryback period, and current losses will result in loss carryforwards that will expire unused unless the current 5-year carryforward period is extended. Savings banks and other financial institutions should at least enjoy parity with other corporations with respect to the carryback and carryforward period over which losses may be deducted. Recognizing the equity of this position would require a legislative amendment which would provide savings banks and other financial institutions with at least an additional 3 years carryforward—resulting in a carryforward of at least 8 years.

Investment tax credit

The National Association of Mutual Savings Banks would like to bring to your attention an inequity in the tax laws which should be addressed with any proposal relating to the taxation of mutual savings banks. Mutual savings banks and savings and loan associations are limited under Section 46(e) of the Internal Revenue Code to an allowable investment credit equal to one-half of that permitted to other corporations, including commercial banks.

This limitation was presumably incorporated in the law because of the fact that mutual savings banks and other thrift institutions have the option of utilizing the special percentage-of-income bad debt deduction in computing their tax liability. This special bad debt deduction was provided for in the 1969 Tax Reform Act, which substantially altered the method of taxing mutual savings banks and other thrift institutions. Under the special bad debt deduction, savings banks may deduct a specified percentage of taxable income in computing their bad debt deduction and the degree to which this deduction may be utilized relates directly to, and serves as a stimulus to, investment in residential mortgages. To realize the full advantage of

the special bad debt deduction, it is essential that a high percentage of a savings bank's assets be invested in residential mortgages.

While this special bad debt deduction has proved to be an incentive to investment in housing, the effect of the 1969 law has been to increase significantly taxes paid by thrift institutions, at least until the recent earnings crisis. Furthermore, under the statutory authority establishing the special bad debt deduction, the applicable percentage in arriving at the special bad debt deduction has decreased from an original 60 percent of taxable income in 1969 to the present 40 percent, at which rate the deduction is scheduled to remain. In addition, the present earnings situation of most thrift institutions need not be elaborated on, and in the face of substantial losses, the special bad debt deduction, based as it is on taxable income, becomes irrelevant. A combination of the reduced applicable percentage and the earnings situation throughout our industry render the special bad debt deduction far less advantageous to mutual savings banks and other thrift institutions.

It is the position of our industry that the limitations on the investment credit available to thrift institutions has little justification, particularly in view of the decreased significance of the special bad debt deduction. Furthermore, today most savings banks do not utilize the special bad debt deduction and compute their reserve for bad debts and ultimate tax liability in the same manner as other corporations, including commercial banks, which all utilize the full benefits and incentives of the investment tax credit.

The arbitrary limitations imposed upon savings banks and savings and loan associations become apparent with reference to recent developments in the field of electronic banking—an area which is only beginning to realize what will be major innovations in all areas of banking. By its nature, electronic banking and electronic funds transfer involve significant investment in computers and other equipment. The savings bank industry would suffer a crucial disadvantage in its efforts to compete with commercial banks and other financial conglomerates, such as Sears and Merrill Lynch, in the emerging area of electronic banking if savings banks are unable to utilize the same investment opportunities as commercial banks and other corporations which are entitled to 100 percent of the investment tax credit.

In this connection, we would request that the Committee consider the possibility of repeal of Section 46(e) of the Internal Revenue Code and thereby eliminate the limitation on the use of the credit by thrift institutions.

Minimum tax

Under present income tax rules, the excess of the special percentage-of-income bad debt deduction for thrifts over actual bad debt experience is considered to be a so-called preference item and subject to the minimum tax. This tax is imposed at the rate of 15 percent of such tax preference items in excess of the greater of $10,000 of the regular income tax.

The Administration has proposed to repeal the minimum tax and replace it with a new "alternative minimum tax." Under this proposal, savings banks and other corporations would be required to pay the greater of their regular income tax or an alternative tax equal to 15 percent of their so-called "alternative tax base," which will equal regular taxable income plus tax preferences, less $50,000. The special bad debt deduction in excess of reserves available on the basis of experience, as well as the excess of accelerated depreciation over straight-line, would continue to be preference items. While we do not have all the details of this proposal, the above formula would appear to have a substantially greater impact than the current minimum tax given the same income and tax preference figures.

The savings bank industry takes the position that the purpose for granting the special bad debt deduction—to stimulate residential mortgage investment—is to some extent contravened by subjecting this deduction to the minimum tax. Any increase in the minimum tax obviously would compound the reasons for our opposition to subjecting the excess special bad debt deduction to treatment as a preference item.

Stock savings banks and the qualifying assets test

The National Association of Mutual Savings Banks strongly supported those amendments to Sections 591 and 593 of the Internal Revenue Code included in the Economic Recovery Tax Act of 1981, which made those sections applicable to so-called stock savings banks. As stated above, Section 593 of the Code provides a special bad debt deduction for thrifts and recognizes the fact that the investment powers of our institutions as dictated by the state laws in which our banks operate reflect a commitment to long-term residential mortgages and related investments.

Present law requires that 72 percent of a mutual savings bank's assets be so-called "qualifying assets" if the savings bank is to receive the maximum benefit of

the special percentage-of-income bad debt deduction. We were, and continue to be, in complete agreement that the authorization of a mutual savings bank to convert to a stock savings bank—which would in no way reduce our commitment to the residential mortgage market—should not preclude utilization of the special thrift bad debt deduction.

However, we do question the justification for increasing the required investment standard from 72 percent of assets to 82 percent of assets as required under the Economic Recovery Tax Act of 1981. The investment requirements of our institutions under state law will presumably not be affected by any conversion to stock form, and there seems to us to be no justification for that provision of the Economic Recovery Tax Act which requires a more restrictive investment posture for stock savings banks to take advantage of the maximum benefit of the special bad debt deduction.

Taxability of discounts on mortgage redemptions

Mutual savings banks, in an effort to restructure their mortgage portfolios, have increasingly offered mortgagors the opportunity to pay off low-rate mortgages at substantial discounts, thereby making available funds for housing and other investment at current rates. The ability to accomplish this important program has been hindered by uncertain tax consequences to the mortgagor as a result of these transactions. the savings bank industry urges the Committee to consider legislation which would make it clear that the retirement of mortgage obligations prior to maturity at a discount does not result in taxable income to the mortgagor. Such a determination would have little if any revenue impact to the Treasury while at the same time would contribute to relieving current pressures on the thrift industry. Low-yielding mortgage portfolios are, without question, the root cause of the current crisis in our industry, and enhancement of the ability to restructure those portfolios will help avoid the much larger federal expenditures, which will be required in dealing with financially distressed thrift institutions.

Preemption of State and local franchise taxes

We would also call to your attention the very serious problem of local franchise taxes. As we have indicated earlier, mutual savings banks are currently experiencing extreme earnings pressures. The mutual savings bank industry lost approximately $1.5 billion in 1981 and under reasonable interest rate projections, losses will increase substantially in 1982.

Notwithstanding these heavy losses, some states and localities, most particularly the States of New York and Massachusetts and the City of New York, levy a franchise tax on mutual savings banks. The tax is based on the volume of deposits without regard to whether a bank is making or losing money. We believe that imposition of such a franchise tax is extremely unwise given the perilous condition of many thrifts and believe that Congress should move to federally preempt the imposition of such a tax. In this vein, we note that the Chairman of the Federal Deposit Insurance Corporation has recognized this problem and, in testimony before the Housing Subcommittee of the House Banking Committee on the legislation to assist thrift institutions, called for federal action to address the franchise tax issue.

Conclusion

In conclusion, we continue to believe that increased incentives to save and invest will have the most beneficial effect on the nation's economic problems, and ultimately the budget deficit, and to this end we urge consideration of the foregoing provisions.

STATEMENT OF THE NATIONAL ASSOCIATION OF PRIVATE PSYCHIATRIC HOSPITALS

Mr. Chairman, the National Association of Private Psychiatric Hospitals appreciates the opportunity to share its views concerning the administration's revenue raising proposals with the Committee.

The National Association of Private Psychiatric Hospitals represents the nation's 203 freestanding (non-governmental) psychiatric hospitals and related hospital-based psychiatric services. The hospitals, with more than 24,000 beds, represent a variety of types of ownership and provide for the medical care and treatment of persons suffering from psychiatric disorders and impairments. The membership offers the wide and varied range of competitive hospital-based programs critical to addressing the needs of children, adolescents, adults, the elderly, the alcoholic, and the substance abuser. All of our member hospitals are accredited by the Joint Commission on Accreditation of Hospitals, the national agency for voluntary accreditation of hospitals.

The major concern of NAPPH with regard to the administration's revenue proposals is the Treasury Department's proposal to impose restrictions on the use of tax-exempt bonds by nongovernmental hospitals. The stated goal of the Department in proposing new restrictions is to reduce both the federal deficit and the impact on the municipal bond market. These goals are to be met by imposing conditions on bond issuance to assure that such tax-exempt obligations serve "legitimate public purposes." We believe that the application of these proposals to hospital revenue bonds and to hospital use of industrial development bonds would not advance the Department's desired objectives to any significant extent and would fly in the face of another administration priority—the reduction of health care costs.

Hospital revenue bonds

There can be little question that not-for-profit hospitals serve a public purpose by helping to maintain the health of the community. Governmental controls, though state and local health planning agencies, rate-setting bodies, and bond issuing authorities, effectively assure that hospital capital projects meet genuine community needs. Market forces also act to control unnecessary projects as investors assess the "need" for a proposed project by determining whether or not there will be a reasonable expectation that it will generate sufficient revenues to service the debt.

The goal of the Treasury Department to include hospital bonds in the proposed restrictions on tax-exempt financing seems to be based on certain prevailing myths and on a misunderstanding of the need for tax-exempt hospital bonds. We do not believe that restricting the availability of hospital revenue bonds will have any significant effect on reducing the deficit. The Congressional Budget Office (CBO) estimates first year savings of approximately $100 million, rising to about $600 million annually by 1986. Yet, these CBO estimates of revenue gains do not take into account the consequences of restrictions on hospital bonds, such as: (1) subsequent losses to the federal government due to higher interest expense under Medicare and Medicaid; (2) losses to the federal treasury from a reduction in economic activity that is generated as a result of hospital investment in needed modernization, improvement, and expansion; and (3) the fact that many investors in hospital bonds will find other non-taxable (and possibly non-productive) investments, rather that investing in taxable bonds. Thus, we urge the Committee to be wary of any exaggerated claims of measurable savings resulting from limiting the use of hospital revenue bonds. In addition, the Treasury department has shown no evidence to substantiate its claim that the volume of tax-exempt hospital bonds has any significant effect on municipal bond interest rates.

It has been asserted that the growing use of hospital revenue bonds has led to excessive hospital expansion. In fact, however, there is simply no evidence to suggest any causal relationship between the issuance of tax-exempt hospital bonds and an increase in hospital construction. The primary use of tax exempt financing has not been for new construction but rather for the refinancing of existing debt, usually at lower cost; renovation of exsisting facilities; and/or conversion of facilities to new uses. These uses tend to reduce health care costs. Previous testimony on this subject before the Senate Finance Committee showed that there actually has been a negative correlation between the issuance of hospital revenue bonds and the amount of construction, including renovation, replacement, and facility conversion. From 1972 to 1979, the dollar volume of tax-exempt hospital bond issues increased 670 percent; but hospital construction starts declined by 40 percent and construction completed by 36 percent. From 1974 to 1979, between 25 and 46 percent of the volume of tax-exempt bond issues was for refinancing existing debt at lower interest rates.

It is true that the volume to tax-exempt hospital bonds has grown substantially in recent years. However, this movement has been necessary for hospitals to meet their capital needs because the federal government's fiscal policies do not provide reimbursement that fully covers the costs of services. This situation will be exacerbated if proposed Medicare-Medicaid budget cuts are adopted. Furthermore, tax policies (as enacted in the 1981 Tax Act) will have the likely effect of reducing charitable contributions on which not-profit hospitals have relied so heavily in the past. Therefore, if tax-exempt financing is restricted, hospitals will be forced to turn to the taxable bond market as a primary substitute source of capital. Yet, the markets view non-profit hospitals as undesirable long-term risks because of the increasing revenue shortfalls caused by the aforementioned government policies. Consequently, hospitals will pay a higher premium in higher interest rates and shorter terms. This situation will make it extremely difficult for many hospitals to finance needed renovation, replacement, and conversion of facilities which will be necessary, especially if the non-profit hospital is to succeed in the anticipated competitive environment.

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Two of the proposals, in particular, which restrict use of tax-exempt hospital bonds would, in effect, terminate their availability. We find such proposals to be both harmful and counterproductive when already too few alternatives exist for hospital financing. The first proposal would require approval by the highest elected official or legislative body of the governmental unit issuing the bonds. As presiously mentioned, this is duplicative of the existing governmental control and review mechanisms, which assure that projects meet public needs. This proposal would needlessly delay construction, thus increasing project costs to hospitals and, consequently, to the government. The second proposal would require that for all bonds issued beginning in January 1986, the governmental unit make a contribution or commitment to the facility financed with tax-exempt bonds. This proposal would have the effect of rationing health care to those localities that could afford to contribute. Many urban and rural communities are already hard pressed to support services that the federal government is no longer providing—additional contributions would be near impossible.

In conclusion, the problem of attracting affordable capital is expected to be a critical issue facing hospitals in the coming decade. It is estimated that approximately $150 billion will be needed by hospitals in the 1980s for capital projects. In 1979, tax-exempt financing was the source of 55 percent of all hospital construction capital. Restricting the ability of hospitals to undertake needed capital improvement projects would, in the long run, lead to an increase in the cost and a reduction in the quality of health care. We trust that the Committee will agree that neither of these ends is acceptable.

Hospital use of IDBs

We would briefly like to address the proposed restrictions on the availability of tax-exempt "small issue" industrial development bonds (IDBs) to hospitals. To begin with, NAPPH agrees with the Congressional Budget Office and Treasury Department that there have been abuses in the IDB program and that some type of reform is necessary. In 1981, after hearings on the use of small issue IDBs, Congressman Rangel, Chairman of the Ways and Means Oversight Subcommittee, introduced legislation to address these abuses and to restrict the availability of small issue IDBs. While NAPPH has some concerns about the "sunset" provision of the legislation, we applaud the Committee's recognition that financing of hospitals with IDBs has never been criticized and is in the public interest. We believe that the exception for hospital financing with IDBs without regard to the size of the corporate enity, included in H.R. 4420, should be included in any proposal to limit the availability of such bonds.

Statement of the National Association of Surety Bond Producers

The National Association of Surety Bond Producers (NASBP) is an organization of over 700 insurance/bond agencies and brokerages which specialize in providing contract surety bonds to construction contractors. It is estimated that in excess of 65 percent of the contract surety bonds written in the United States are provided through NASBP members.

The primary function of suretyship is to prequalify a contractor for an owner of a construction project. This prequalification function requires sureties, and the professional bond agents and brokers who represent sureties, to thoroughly investigate and analyze all aspects of a contractor's capacity to perform the job, including, certainly his financial capacity. Surety agents and underwriters, therefore, are well qualified to speak on the unique financial and accounting characteristics of the construction industry.

In this statement, we would like to offer our comments on the proposed elimination or significant modification of the use of the completed contract method of accounting by construction contractors. While we understand that defense contractors and certain other manufacturers also utilize the completed contract accounting method for taxes, we are specifically concerned about the effect that any change in completed contract accounting would have on construction contractors, including general bulding contractors and the numerous trades including plumbing, heating, air conditioning, electrical, roofing, and sheet metal contractors to name a few.

The vast majority of construction contractors are small business which often are cash poor and require infusions of cash from their owners or creditors. They are vulnerable to economics and other competitive business pressures to a greater extent than large firms because of their limited size.

The construction industry is highly competitive, and firms are forced to narrow their profit margins to an extent usually not compatible with the risks inherent in their operations. Low profit margins and the general lag of receipts behind expendi-

tures often cause critical cash flow problems. The current high interest rates and inflation only exacerbate this situation.

The cost and availability of financing for construction contractors is affected by the unusual risks to which contractors are susceptible. One of the greatest risks stems from the method of pricing. Prices are fixed before costs are accurately determined. Unexpected events which result in additional costs could therefore have a serious affect on contractor's profitability. As a result it is usually difficult to ascertain with any degree of certainty the profit or loss on a construction project until the project is completed.

In addition, most construction contracts have some form of "retention" provisions. The amount of this "retention" often exceeds the total estimated profit from the contract. At the very least, it is ordinarily a large portion of the profit. Contractors are thus faced with the prospect of expending large sums over a period of months or years, with the very real possibility that the payments received from their construction contract funds will not cover the amounts expended on the contract until the job is complete and all retention is released.

Because of these factors, and the inherent uncertainty in determining profits on an interim basis, contractors traditionally have elected to use the completed contract method of accounting for tax purposes. Eliminating this accounting method, and imposing a requirement for the payment of taxes based on interim contract performance would seriously increase and complicate the financing burden of many contractors. The further strain placed on a contractor if forced to finance interim federal income tax payments as well as his normal working capital requirements, would reduce his capacity to take on new work. From the viewpoint of NASBP members and the companies which underwrite contract surety bonds, such a situation would reduce the contractor's ability to secure additional surety credit. And without such surety credit, the contractor would not be able to undertake any additional public work.

When viewed in this light, and considering the cost of financing at today's high interest rates, it is apparent that the elimination of the completed contract method of accounting could severely hamper a contractor's ability to operate and expand. Competition in the industry would thus be reduced, and the cost of construction would increase.

While we are not qualified to address the need for dealing with any abuses of completed contract accounting by defense contractors and others using this accounting method, we urge that the substantial differences between these huge concerns and the typical small-to-medium sized construction contractors be recognized and that no change be required in the long-standing use of the completed contract accounting method for construction contractors.

Statement of the National Council of Health Centers

SUMMARY

Currently Congress is considering placing a number of limitations on the issuance of industrial development bonds;

These restrictions would have the effect of halting virtually all nursing home construction in this country.

Fact: The number of Americans over 65 is expected to increase from 25.3 million in 1980 to 30 million by 1990.

Fact: Five percent of the elderly are in nursing homes; three times that many could use nursing home services if their families didn't provide the care.

Fact: An additional 230,000 nursing home beds will be needed by 1990, just to maintain today's current inadequate ratio of beds/elderly population ratio.

Fact: In 1980, over $1.5 billion added Medicare/Medicaid expenses were incurred by patients in hospitals awaiting an available nursing home bed. This figure will only increase so long as there is a surplus of hospital beds and a shortage of nursing home beds.

Fact: Investor-owned multifacility nursing home firms are the principal source of new nursing home construction in this country.

Fact: For nursing homes, including multifacilities, there is no alternative source of financing available.

Conclusion: Any legislation to limit small issue industrial development bonds must provide an exception for nursing home construction with no restrictions regarding the size of the corporate entity.

STATEMENT

The National Council of Health Centers would like to take this opportunity to comment on the Administration's proposals for Industrial Development Bonds as they impact nursing home providers.

Members of the National Council are investor-owned multifacility nursing home firms with a minimum of 1500 beds in two or more states. Our member firms also provide many other health related services such as home health, alcohol and drug rehabilitation programs, retirement centers and hospice services.

We are extremely concerned about the proposals being considered with regard to severely restricting small issue industrial developent bonds. Much of the attention to date has focussed on the use of small issue IDBs for industrial or retail concerns. Any discussion about the impact on health facilities has centered on hospitals. Few realize the importance of this source of financing for investor-owned nursing homes. The fact is that with the limitations currently being considered for industrial development bonds, new nursing home construction in this country would cease.

Proprietary nursing homes, which comprise more than 70 percent of the 18,900 nursing homes in this country, are almost exclusively reliant upon small issue IDBs for the financing of new facilities and for expanding and improving their existing nursing homes. Our multifacility members have said this is the only form of financing available to them today. With the proposals being advanced by the Administration, and others, this source of capital financing for nursing homes would be virtually eliminated.

The need for new nursing home beds is critical. To substantiate this, one need only look to the number of states reporting serious backlogs of patients in hospitals awaiting nursing home beds. These states include Connecticut, Massachusett, California, Michigan, Georgia, Minnesota, New York, and the District Columbia. In 1980, the cost to the Medicare and Medicaid programs for this backlog was more than $1.5 billion.

By eliminating or restricting the source and amount of financing available for new nursing home beds the direct effect will be an increase in patients retained in hospital beds awaiting an appropriate lower level of care. Thus the $1.5 billion added Medicare/Medicaid expenses incurred in 1980 will grow even larger. So long as there is a net surplus of hospital beds and a shortage of nursing home beds, this situation will continue.

We have estimated the need for $10.6 billion in capital to construct the additional 260,000 nursing home beds which will be required by 1990. The figure 260,000 beds is a conservative one as it would merely maintain today's current bed/elderly population ratio which, as pointed out, is completely inadequate. We cannot ignore the fact that the over 65 population is the most rapidly growing segment of our population. As more people live longer, their health needs inevitably increase. We cannot afford to halt nursing home construction.

From the perspective of nursing home construction costs, any potential tax revenue gains obtained by limiting IDBs would be more than offset by increased Medicare/Medicaid costs due not only to the hospital backlog, but also through increased financing costs which are reimbursable expenses under these programs. Clearly it is shortsighted to restrict small issue IDBs for nursing home construction if it were to result in increased costs, rather than savings.

Our greatest concern lies with the proposal to restrict small issue IDBs to firms with less than $20 million worth of capital expenditures in a six year period and no more than $10 million worth of IDBs outstanding nationwide. This proposal is needlessly discriminatory against larger firms and as multifacility nursing home providers we are not only opposed, but also question its logic and relevancy.

At the present time multifacility nursing home firms are the principal source of new construction in the industry. Single facilities and smaller groups have neither the expertise nor the financial standing to engage in significant expansion. Multifacility firms have the resources and financial stability for building nursing facilities and are able to benefit from the efficiencies and economies gained from their size. Multifacility firms are able to hire full time specialists such as therapists, dietitians and physicians to provide care to their nursing home patients. They also benefit from increased purchasing power, economies of scale and systems approaches to improving patient services. As a result, multifacilities are able to provide quality care for a reasonable cost.

Because there is no other source of financing available for nursing homes, it is imperative that nursing home construction be encouraged. No limitations should be placed which would effectively exclude participation by multifacility nursing home firms.

It is important to remember that nursing homes are labor intensive, rather than capital intensive, and that every facility constructed provides many jobs to local communities. For each 120 bed facility, 66 full-time equivalent jobs are provided. Frequently, these are unskilled workers who undergo intensive training programs to become nurses' aides, dietary assistants and social services aides. Thus nursing homes not only provide valuable jobs for unskilled workers, they also increase their opportunities for personal improvement and upward mobility. In addition, as opposed to non-profit institutions, nursing homes provide billions of dollars to federal, state and local governments in sales, income and property taxes.

We are opposed to the Administration's proposal for a contribution by the community of an amount equal to one percent of the bond's value. This provision could well mean that communities with the greatest economic need for new industry or for long term care services would not be able to benefit because they could not afford to make that contribution.

Another issue being debated is whether IDBs are issued for a "public purpose". This has primarily focused on the abuses by large retail franchise concerns. We suggest that legislation be enacted to eliminate these "abuses" rather than being punitive to all those wishing to use this form of financing, regardless of the project's value or utility.

Further, there is an implied impression that proprietary or investor-owned institutions by their nature do not "serve a public purpose". This seems rather ironic if one considers the studies which show that proprietary nursing homes have a higher proportion of Medicaid patients than non-profit nursing homes. In addition, they provide services to these patients at a lower cost. Medicaid patients comprise nearly 60 percent of the patients in proprietary nursing homes. If, like hospitals, most of the nursing homes in this country were non-profit, public expenditures for long term care services would be even 25 or 30 percent higher.

We suggest that health facilities already have a determinant of "public purpose" in place through the Certificate of Need process. Local HSAs comprised of community leaders review each new construction project to determine need and worth. While it is true that federal participation in health planning may be phased out, each state has enacted its own legislation, either Certificate of Need or 1122 Review, which would carry on this activity. In addition, each project and the firm proposing it is scrutinized and reviewed intensely by the local sponsoring community or authority.

Many states have recognized the increased demand and special financing needs of health facilities by enacting legislation to establish health facilities financing authorities. These bond issuing authorities provide another layer of public scrutiny as to a project's feasibility, worth and fulfillment of community needs.

In summary, we suggest that the small amount of tax revenue savings which might be gained by limiting small issue IDBs for health facilities, is not at all proportional to the tremendous impact it will have on future construction. For nursing homes, new construction will cease and this will mean increased costs to the Medicare and Medicaid programs because of an even greater number of patients backed up in hospitals waiting non-existent nursing home beds.

For nursing homes it is critical that a provision such as that included in H.R. 4420, to provide exceptions for health facility financing with IDBs, without regard for the size of the corporate entity, be included in any proposal to limit the availability of such bonds.

Statement of Preston Butcher, Cochairman of the National Multi Housing Council

SUMMARY

The Administration's proposals on industrial development bonds, particularly the prohibition on the use of accelerated depreciation and asset life provided by the Accelerated Cost Recovery System, should not apply to revenue bonds for multifamily housing for the following reasons:

1. These proposals would effectively end tax-exempt financing for rental housing, which is the only way new rental housing can be produced in the current economic environment or in the foreseeable future.
2. There is no "double-dipping" on tax incentives since the 1981 Economic Recovery Tax Act provided no significant improvement in the tax treatment of rental housing.
3. The use of revenue bonds for rental housing has already been tightly restricted by the Congress in the Mortgage Subsidy Bond Tax Act of 1980.

STATEMENT

Mr. Chairman, Members of the Committee, I am pleased to submit this testimony, on behalf of the National Multi Housing Council, on the matter of the Administration's proposals with regard to industrial development bonds.

The National Multi Housing Council is a nationwide association of builders and operators of multifamily housing. I present this testimony in my capacity as Co-chairman of the Council and President of the Lincoln Property Company of Foster City, California. Lincoln Property builds and manages multifamily housing in 14 states and 49 cities, and is the single largest builder of rental housing in the country today.

As builders of rental housing, the National Multi Housing Council is concerned with the Administration's proposal to bar projects which receive tax-exempt financing from taking advantage of accelerated depreciation as provided by the 1981 Economic Recovery Tax Act. If enacted, such a provision would eliminate the one set of circumstances under which rental construction may be feasible today—when financing at tax-exempt rates can be combined with the investment incentive provided by the Accelerated Cost Recovery System. We are also concerned that several of the Administration's other proposals on IDBs would significantly increase the cost of and the difficulty of obtaining financing for rental housing.

High interest rates over the past two years have pushed the entire housing industry, multifamily and single family producers alike, to the brink—if not over the brink—of disaster. Thus, on the simplest level, this is not the time to place an added burden on housing credit.

More important, however, is the fact that the crisis afflicting rental housing is far more severe, of longer duration, and more deeply rooted than the problems with homeownership. Unsubsidized rental production has dropped steadily over the past five years and has been at a virtual halt for the past two years. Construction starts in unsubsidized rental projects have fallen from more than 200,000 units in 1977 to approximately 50,000 a year in 1980 and 1981. And nobody I know believes 1982 will be any better.

The reason for the disappearance of unsubsidized rental construction is simple: rental housing is a risky and not very profitable investment. High construction, financing and operating costs require high rents in new rental projects. Yet tenants are unable or unwilling to pay rents at these levels, seeking instead the tax and appreciation benefits of homeownership. Compounding this basic feasibility problem is the fear of local rent controls and restraints on condominium conversions.

In this environment, tax-exempt financing is essential to bring rents down to affordable levels and accelerated depreciation is necessary in order to attract capital. Thus, an apartment that cost $45,000 to develop would require a rent of approximately $660 per month, if financed at a tax-exempt 13½ percent interest rate and if the tax incentives provided by ACRS enable the project to attract investors for little or no direct return on their investment. If tax-exempt financing is unavailable, the cost of 17½ percent conventional financing would raise rents by $140 per month. If accelerated cost recovery, however, is not available, and the project must use straight line depreciation over a 35 year period, rents would have to be approximatley $300 per month higher over the first four years to make up for for the lost depreciation.

This analysis tells us two things. First, if forced to choose between tax-exempt financing the ACRS, builders will almost inevitably take the accelerated depreciation. Second, and far more important, under anything like current market conditions, rental housing simply will not be built without both low-cost financing and accelerate cost recovery. In fact as, the Congressional Budget Office pointed out in a paper issued last month, even with tax-exempt financing and ACRS, "most developers do not find rental housing profitable" today. Thus, unless this Committee wnats to stop what little rental construction is going on today and to prevent any resurgence in the future, it must at minimum exempt multifamily housing bonds issued pursuant to IRC Section 103(b)(4) from the Administration's proposed "choice" between tax-exempt financing and ACRS.

It is also significant that the Administration's offered rationale for this choice—that businesses should not be able to "double dip" on tax incentives—is not applicable to rental housing. In the 1981 Act, rental housing did no more than break even compared to its pre-1981 tax treatment, and it did so while other industries improved their positions significantly. While ACRS gave rental projects a shorter, audit-proof life, this improvement was offset by the loss of the double declining balance method for most projects and the drop in the maximum tax rate. As a result, rental housing receives roughly the same level of tax incentives now as it did before

the 1981 Act; there is no "double dip." By seeking to preserve accelerated depreciation together with tax-exempt financing, the producers of rental housing are merely trying to hold on to tax treatment equivalent to that which existed previously—and under which rental production had already fallen to severely depressed levels.

I would also note that, regardless of what action the Congress takes on the Administration's IDB proposals, it has already become significantly more difficult for states and localities to use tax-exempt bonds to finance rental housing. This is because with the apparent termination of federal housing development subsidies it will become extremely difficult for projects to comply with the 20 percent low income requirement established by the 1980 Mortgage Subsidy Bond Tax Act. As long as Section 8 housing subsidies were available, they could be used to provide the required low income units. Now, however, the Administration proposes to terminate most rental production subsidies. This will require project owners to raise rents on most apartments in order to keep rents for 20 percent of the units affordable to low income households. Because that sort of "rent-skewing" can take place in only relatively few projects, we believe that even without the Administration's proposals, the 20 percent low income requirement will cut sharply into rental production through tax-exempt bonds. This is a far cry from the "flood" of "private purpose bonds" which critics have seen as justifying the Administration's proposed restrictions.

Turning briefly to the Administration's other proposals with regard to IDBs, I would note that several of these are simply not relevent to bonds for rental housing, and it is not clear whether it is the intent of the Treasury to apply them to such bonds. Two of these proposals, however, would have a serious impact on multifamily bonds, if applied to them. The first is the requirement of a government contribution or commitment to a facility financed with tax-exempt bonds after 1985. In terms of rental housing, this requirement is neither necessary nor advisable. It is not needed because local governments already make significant contributions to assure the feasibility of projects built with tax-exempt funds. It is unwise because, with the dismal record of Treasury in providing regulations for housing bonds, there is every likelihood that a simple, well-intentioned requirement which Congress puts into the law will be turned into a bureaucratic monstrosity, used to frustrate the very purposes the bonds are intended to serve. One need only look at the regulations for single family revenue bonds and the Treasury's failure after nearly 1½ years to issue regulations for multifamily bonds to realize that this is not an idle fear.

The second troublesome proposal is that which would limit investment yield during the construction period. This, too, provides an opportunity for Treasury's bureaucratic meddling. In addition, it will increase the cost and decrease the feasibility of bond issues.

In conclusion, Mr. Chairman, I would reiterate that tax-exempt bonds for rental housing ought to be entirely excluded from the scope of the proposed changes in industrial development bonds. Multifamily bonds are not the source of the concerns expressed by the critics of IDBs: their use has dropped steadily over the past two years and they are already targeted by law. In addition, there is no "double-dipping" of tax benefits. And most importantly, if there is to be any serious hope for a revival in rental construction, which this Nation desperately needs, tax-exempt financing must play a significant role.

Thank you for your attention.

STATEMENT OF GALE CINCOTTA, CHAIRPERSON, NATIONAL PEOPLE'S ACTION

My name is Gale Cincotta. I am Chairperson of National People's Action, a coalition of grassroots community organizations in small and large urban areas throught this country.

Allow me to start off by showing you what appeared on the front page of my newspaper, the Chicago Tribune, last Saturday, April 3, and what I know you saw when you opened your newspapers as well: 9 Percent Jobless! (Exhibit 1) 9.9 million people out of work—the highest official unemployment rate since World War II! That headline, as you may know, is deceiving, portrays in fact the tip of the unemployment iceberg. That official Labor Department figure of 9.9 million does not include those Americans so discouraged at the prospect of another rejection that they have stopped looking for work altogether—another 3.5 million. And to this you can add a record 5.7 million people who are working part time, not because they want to, but because they cannot find what they really want and need—a full time job.

So let's get something straight from the beginning. We're not talking about 9.9 million Americans who cannot find gainful employment. We're really talking about a whopping 16.9 million jobless—nearly 17 percent of the labor force! More people

unemployed, to put it graphically, than there are people in Connecticut, Minnesota, Oregon and South Carolina combined! And with 75 percent of the unemployment due to lay-offs of primarily blue collar workers, we're not talking about a recession. We're talking about a depression!

Everyone is paying the price for unemployment, not just the unemployed themselves.

The closing of large and small plants by the country's giant corporations is by now a daily occurrence. America's productivity is suffering in just about every arena. In 1980 alone, 30 auto plants closed idling 63,000 workers. Unemployment within the auto industry now stands at a record 21 percent! The lumber industry has thrown 18 percent of its workforce out on the streets—946,000! U.S. Steel, Zenith, General Tire, Singer, International Harvester, the list goes on and on.

Small neighborhood businesses and manufacturing firms, employing six out of every ten Americans, are closing their doors at record rates. 15,000 filed for bankruptcy in 1981 alone!

The cutback of workers on the federal level is also well known. But local government, a traditional source of jobs for many city dwellers, has cut its ranks by 250,000 last year. And with these 250,000 jobs went many of the vital day to day survival services that are provided only at the local level.

And this unemployment news for a federal administration and Congress bent on cutting budget costs is particularly ironic. It costs the federal government an additional $30 billion—that's right, $30 billion—for every 1 percent increase in the national unemployment rate according to the Administration's own findings.

Even the opportunity for employment is being drastically curtailed. The Administration proposed in its 1983 budget to cut by $2.6 billion outlays for training and employment programs. And I trust that I do not have to remind this body of the kind and extent of the consequences suffered in the late 1960s by this nation's cities as a result of denying its citizens the basic opportunities to live a decent life, under a decent roof, earning a decent wage.

One would think that unemployment the size and magnitude of the Great Depression would make obvious the need, indeed the demand, for the kind of imaginative thinking and doing by Congress and the Administration that we enjoyed nearly 50 years ago. Yet this is hardly the case! Instead, we are offered at best piecemeal, patchwork remedies designed to apply a bandaid to a patient clearly bleeding to death.

Enterprise Zones are one such example of this bandaid approach. You have heard and no doubt will hear endless debate regarding the merits and demerits of this current Administration proposal. What tax incentives will apply? Which inner city communities will qualify? Which regulations will be scrapped? The Administration has got all of us fighting among one another like dogs and the dinner table fighting for scraps.

And I do mean scraps! According to HUD, nearly 2,000 inner city neighborhoods will qualify for these zones. And what has the Administration offered us the first year? 75!

Let me suggest, if I may, two points worth considering when evaluating the Administration's Enterprize Zones proposals:

(1) The proponents of this legislation emphasize "the use of community based organizations" in the implementation of these zones. This is merely a ruse to garner the support of an unknowing public and Congress desperate for relief. In my twenty years of experience with community based organizations at the grassroots level, I have known of no community group truly representative of its constituency that sanctions, tolerates, let alone would think of proposing an elimination of minimum wage requirements and occupational safety regulations as has been strongly urged by some proponents of these zones.

(2) The need for the kind of federal subsidies and handouts proposed for big business as part of these zones is testimony in itself to the failure of the Administration's assertion that big business can on its own solve our unemployment problems. If the free enterprise system, at least as proposed by the administration, works so well, why do we need the massive subsidies of an enterprize zone? These zones demonstrate the Administration's desire to have it both ways: handouts for big business and hands off for big business. We can't have it both ways, why should big business?

I wish to suggest to this body that the solution for this country's unemployment, lack of productivity and sagging revenues lies not in top down solutions like Enterprise Zones, but rather in the initiatives now underway at the grassroots level, particularly on the part of neighborhood organizations. Let me give you a few examples of the potential:

(1) Washington, DC's WISH organization (Washington Inner City Self-Help) is working with the Targeted Job Tax Credit program, a federal initiative administered locally, that provides an employer with tax relief of up to $3,000 in the first year and $1,500 duing the second year for each qualified unemployed person hired. This progam is in place right now. If working properly, it combines the efforts of the unemployed, business and local government to target resources toward increasing employment where it's needed most, in older city neighborhoods among the hard core unemployed. There is no one we talked to who has used the program that has a complaint about it. In fact, the only complaint we've heard is that it isn't publicized enough. Not enough people even know that it exists!

(2) In Chicago, the Henry Horner Jobs Coalition is involved with some of the city's corporations and with the Economic Development Corporation there in an effort to see that industrial revenue bonds are targeted towards the job creation promised by the city to its neighborhoods.

Again, this is a program that is already in place not just in Chicago, but as you know, in hundreds of cities across the country.

Millions, indeed probably billions of dollars are being loaned at well below market rates to thousands of corporations in exchange for the pledge to create new jobs for the unemployed. As you know, the banks pay absolutely no federal taxes on the millions of dollars in interest collected each year on these loans. It is a program that on paper at least should be creating thousands of jobs. Enough jobs to more than offset the loss of federal revenue due to the tax exempt status of these small issue bonds. Yet this program is riddled with abuses. (Exhibit 2).

In Chicago, for example, $157 million of industrial revenue bonds have produced only 555 jobs, less than a third of what the city claimed in testimony before this Committee.

If this Committee would adopt the recommendations of its Subcommittee on Oversight and monitor the use of these bonds and impose sanctions against their abuse, the jobs created through the bond program would make the suggestion of Enterprise Zones as a solution to joblessness seem trivial.

(3) In Boston, thanks to the Boston Jobs Coalition, that city has adopted by mayoral decree a Jobs Residency Policy. This is a policy that simply mandates that one out of every two jobs created on fedrally subsidized construction projects must go to the unemployed within the city's neighborhoods. This is a policy that is creating jobs right now and that needs your support.

On a national level, last fall leaders of over 100 insurance companies pledged in a letter to President Reagan that as a matter of "public responsibility" they would direct a share of their resources nationwide toward a solution to joblessness, particularly among minority youth. (Exhibit 3). Prudential, in fact, proposed at that meeting that a goal of $5 billion over the next five years be set for this purpose. The future of this initiative will depend on a number of factors, not the least of which is the degree to which these insurance companies will work in partnership with grassroots organizations that represent the unemployed. Congress can and should support this partnership effort between community groups and the insurance indusrty as they have in the field of housing between grassroots groups and banks with the Neighborhood Reinvestment Corporation.

My point is this: the kind of resources needed to address the issues of raising revenue, unemployment and productivity now before this Commitee already exist right in our neighborhoods, among its people.

What is needed now is an investigation of these resources at the local level. This Committee needs to get out of Washington, DC and hold its subsequent hearings in the neighborhoods. In so doing, you will begin to focus this nation's attention back towards its roots where its strength lies and its potential can flourish.

9% jobless!

Illinois is one of hardest hit: 547,000 jobless

By Mitchell Locin

THE RECESSION continued to hit Illinois hard last month as the unemployment rate in the state neared 10 percent, leaving 547,000 Illinois residents out of work, according to government statistics released Friday.

The 9.8 percent unemployment rate for March is 0.2 percent above the 9.6 percent level in February, when 542,000 people were out of work. It also is only 0.1 percent below the state's recession high of 9.9 percent recorded in July, 1980. The national unemployment rate for March was 9 percent.

"We're in worse condition than the U.S. average," said Wally Biermann, an economist for the state Department of Commerce and Community Affairs.

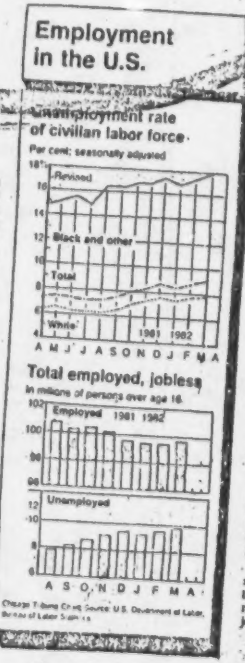
"THE POOR ECONOMY from all indications will persist in Illinois longer than the U.S."

Biermann said he does not expect the Illinois jobless rate to go much beyond 10 percent. "The statistics would indicate we're in a very unstabilized period, but by and large, we are still floating in the bottom trough of the recession."

Although Biermann said the 0.2 percent increase is "not that great," the fact that Illinois continues to be ahead of the national average indicates that recovery will arrive here later.

Economists are revising their forecast that a recovery will begin in early summer, and they are now saying that it will not arrive until late summer, Biermann said. It will not be until early winter, however, before it will come to

Continued on page 4, col. 1


Employment in the U.S.
Unemployment rate of civilian labor force
Per cent; seasonally adjusted
Revised
Black and other
Total
White
1981 1982
A M J J A S O N D J F M A
Total employed, jobless
In millions of persons over age 16
Employed 1981 1982
Unemployed
A S O N D J F M A
Chicago Tribune Graphic Source: U.S. Department of Labor, Bureau of Labor Statistics

Rate in U.S. ties postwar high of 1975

From Tribune Wire Services

WASHINGTON — Widespread layoffs and plant closings pushed the nation's unemployment rate to 9 percent last month, matching the nation's postwar high, the Labor Department reported Friday.

The Illinois rate rose from 9.6 percent to 9.8 percent.

Just under 9.9 million people were out of work in March. Since last July, about 2 million have lost their jobs.

March's employment losses, the product of the continuing recession, cut across the spectrum of the population, with joblessness among adult males, traditionally the family breadwinners, equaling December's high of 7.9 percent, the department's Bureau of Labor Statistics said.

Unemployment among white-collar, blue-collar and full-time workers as a whole rose from February, when the national jobless rate was 8.8 percent.

THE NUMBER of discouraged workers, whom the government omits from the unemployment total because they have stopped looking for work, rose by 140,000 in the first three months of the year to 1.3 million, the highest level since the government began keeping that statistic in 1.6%.

Private analysts say the absence of any clear signs of an early business turnaround indicates there will be no new hiring any time soon of the magnitude needed to provide relief from rising joblessness.

For March, total employment was 99.8 million,

Continued on page 4, col. 1

Chicago Tribune 4/3/82

Exhibit 1

Exhibit 2

Sunday Sun-Times
Chicago, March 14, 1982
★★★★★ Final
$1.00

City gave Congress phony job figures

By Charles Nicodemus

The city's $157 million industrial revenue bonds program has produced only 555 jobs, less than a third of what the city has claimed.

The bonds permit a business to raise funds at bargain interest rates because investors don't have to pay federal taxes on the interest payments they receive.

The low number of jobs produced by the bonds means, in effect, that taxpayers are unfairly subsidizing the businesses and the Treasury is deprived of tax dollars.

A militant community organizing coalition is pressuring the city's Economic Development Commission to help provide some of the jobs that the commission, which is about to become a full-fledged department, says its program has produced.

Meanwhile, a key Congressional subcommittee—responding to complaints from the Treasury Department about nationwide abuses—has recommended pushing for abolition of all small industrial revenue bond programs unless issuing agencies like Chicago's EDC start producing more accurate data about what they're really accomplishing.

In its published figures, submitted to Congress

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Nation 10/4/81

Insurance chiefs pledge job funds

By Kathleen Teltsch
New York Times

NEW YORK — Leaders of more than 100 insurance companies have promised President Reagan that as a "public responsibility" they will direct a share of their resources nationwide toward grappling with unemployment, particularly among minority youths.

The pledge was made in a letter to the president sent Friday in the name of executives who held a two-day private meeting in Chicago last week to formulate the industry's role in community responsibility for the 1980s.

The move is certain to be regarded within the business world as a significant commitment because of the influence and wealth of the industry, which controls $500 billion in assets, employs 1 million people and for more than a decade has been heavily involved in investing funds and lending executive personnel for programs in the inner cities.

Many of the same companies, after the 1967 racial riots in cities across the country, committed themselves to investing $1 billion to help rebuild the stricken cities and another $1 billion later for creating jobs, housing and economic development.

The message to the White House underscored the company leaders' appreciation of the president's statements advocating that government, business and communities work more closely together to meet local needs. It said there were many competing needs, such as education and urban reconstruction, but that the predicament of unemployment, particularly among minority youths, "reaches out to us for priority attention."

The executives did not spell out how they expected to tackle the job issue. But individual companies have agreed to reassess what they are doing locally to create jobs, train youths and work together with community groups on unemployment, and a committee from the group plans to meet again later this month to follow up the initiative.

The Chicago session was not called in response to Reagan's overtures to private enterprise to assume a larger share of the cost and responsibility for community services being curtailed in the administration's new budget. But participants agreed that the challenge from the White House became a dominant theme at their session, which was planned months ago to commemorate the 10th anniversary of a meeting at which officers of 100 health and life insurance companies agreed to work together on improving the quality of life in poorer communities.

They also set up at that time a Clearing House on Corporate Social Responsibility in Washington, headed by Stanley G. Karson, to which member companies report routinely.

In contrast to their $2 billion commitment in 1967, the executives shied away from a specific figure. Robert A. Beck, chairman of the Prudential Insurance Co. of America, proposed setting a goal of investing $5 billion over the next five years, but others were reluctant to make such a pledge, which would be shared on a pro-rated basis.

Prudential is the country's largest insurance company, but those at the meeting included both the giants of the industry and middle-and small-sized enterprises. Some were said to be uneasy because of cash-flow problems.

Exhibit 3

NATIONAL SECURITY INDUSTRIAL ASSOCIATION,
Washington, D.C., March 18, 1982.

Hon. ROBERT DOLE,
Chairman, Committee on Finance, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: We understand that the Senate Committee on finance is conducting hearings on the Administration's tax proposals. We wish to comment on an Administration proposal that would alter both current legislation and the tax regulations affecting accounting for long-term contracts. We would appreciate the inclusion of these comments on this matter as part of the record of the hearings.

The National Security Industrial Association (NSIA) is a national organization of more than 300 manufacturing, research and service companies of all sizes and from all segments of industry interested in and related to our nation's security. NSIA serves essentially as a two way communication medium between government—primarily defense—and the industry which supports it. Although a non-lobby organization, this Association often provides its views, in the national interest, on matters being considered by committees of the Congress which have impact on the national defense and its industrial base.

The proposed change in legislation would eliminate both the completed contract method of accounting and the accrual shipment/accrual acceptance method as well as modify period cost recognition while the proposed changes in tax regulations would affect the manner in which the permitted accounting methods are used. We understand that the Administration's intent is to enhance tax revenues and at the same time eliminate perceived tax abuses.

It is our view that the changes proposed would have an overall long-range adverse effect on the cost of weapons systems, readiness of the armed forces and on the overall strength of the nation's defense industrial base.

If Treasury's estimates are accurate, the proposed regulatory initiatives changing the implementation of accounting methods could achieve some of the objectives of the Administration in enhancing tax revenues. However, the proposed changes would at the same time have a significant impact on the tax burden of defense contractors.

The legislative initiative would provide questionable results and would be disruptive and administratively expensive. We believe final action on the legislative initiative should be taken only if proven justifiable after thorough research to determine if the change would have more than a minimal impact. We are greatly concerned that the legisltive proposal will create additional administrative cost for government and industry, disrupt long-range planning, and create significant uncertainty in the defense industry at a time when the concerned effort of the industry is particularly needed to accomplish the proposed defense program.

The legislative initiative is to eliminate for long-term contract tax accounting both the completed contract method of reporting revenue and the currently acceptable accrual shipment/accrual acceptance method. As you are probably aware, the completed contract method of accounting has been used for tax accounting for long-term construction contracts since 1918. It was proposed for use by manufacturers operating under long-term contracts in the early 1970's primarily as a reasonable compromise position to reduce or eliminate the continuing arguments over estimates of the percentage of contract completion, market values of contract work-in-process inventories, and the higher initial production cost often incurred in defense contracts. For the most part the completed contract method of accounting eliminates these problems—although Treasury has expressed the concern that other problems have been created. We wish to also point out that every contractor, before converting to the completed contract method of tax accounting, received approval from the IRS.

The accrual shipment/accrual acceptance method requires that costs of production be charged against revenue generated upon delivery or acceptance of completed items. Therefore, taxable income or loss is recognized at that time. Progress payments occurring on such a contract would not result in taxable income since, by regulation, progress payments cannot exceed costs actually incurred. In view of this, we believe there is no justification for eliminating the accrual shipment/accrual acceptance method of accounting for taxable income.

The legislative changes will provide only two methods, the existing percentage of completion method and a new progress payment method. As we understand the new progress payment method proposed by Treasury, progress payments and payments for units shipped would be recorded as revenue when received and be off-set by related deductable costs in determining taxable income. Treasury states that "the completed contract method permits income to be deferred for tax purposes long after payments are received and long after income is deemed earned according to

standard accounting practices." While this may be true for some industries, progress payments for long-term defense contracts currently cover only a portion of costs. In addition, reimbursement for units delivered during the life of a contract generally would be based on average unit price. For most defense contracts the cost of producing the first units is higher than the cost of later unit production. Therefore, the average defense contract generally would not produce revenue in excess of cost until the contract is 75 to 80 percent complete.

This modest change in revenue recognition (recognizing cost at the 75 to 80 percent completion point rather than the 100 percent point as under the completed contract method) alone will not produce any increase in tax revenue in the near term and would probably provide only modest revenue increases in the long term. Therefore, we believe the expected modest increase in tax revenue from this legislative change does not justify the extensive effort (in addition to its adverse effects) required to make the change.

The legislative proposal also substantively changes the rules for identifying incurred costs which are subject to being deducted from income in the taxable year incurred (period costs) as opposed to being allocated to an applicable long-term contract and being deductible at a later time. The IRS offers only a cursory reason for this change, i.e., that income is being deferred for tax purposes long after payments are received and income is earned in accordance with generally accepted accounting practices. Although this reason seems to support the Treasury proposal to eliminate the completed contract method, we fail to see its connection to their proposal to redefine period costs. The result of this proposal is to defer deductibility of period costs for tax purposes until revenue has been recognized without regard to whether that revenue is only an accrual rather than a receipt of a payment. Therefore, the proposal is neither good accounting nor good tax policy because it deviates from generally accepted accounting procedures for the sole purpose of enhancing revenue.

In addition, most manufacturers other than those peforming under long-term contracts can use the accrual method without inventorying period cost. The ability to use the accrual method and deduct period cost is proposed to be denied manufacturers performing long-term contracts. To deny these taxpayers the methods available to other taxpayers and at the same time to deny them the completed contract method is inequitable and unduly focusses on defense industry before fully assessing the long-range adverse effects on that industry. We believe it is an unwise proposal for the Administration to make.

The National Security Industrial Association (NSIA), as a very long-term and major voice of defense industry, has volunteered to work with the Administration in examining necessary regulatory changes to achieve proper tax accounting objectives. However, we believe any continued legislative effort to eliminate the completed contract method and to change the treatment of period costs is unproductive and possibly counterproductive to the Administration's objectives of enhancing tax revenues and reducing or eliminating perceived tax abuses.

We feel that all positive action possible should be taken with a view to long-term strengthening of the industrial base and controlling the costs of military systems and supplies. We believe the proposed actions are counter to these objectives.

Sincerely,

WALLACE H. ROBINSON, Jr.,
President.

NATIONAL TAX EQUALITY ASSOCIATION,
Washington, D.C., March 31, 1982.

Re: Fiscal year 1983 tax proposals.

Mr. JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Washington, D.C.

DEAR MR. SALMON: The National Tax Equality Association (NTEA) appreciates this opportunity to comment briefly on the taxation proposals as outlined in the President's fiscal year 1983 budget.

This association was organized in 1943 by businessmen who sought an effective means of expressing their concern about the tax-favored position of cooperatives with which their own businesses were competing. Firms in the grain, lumber, coal, feed, fertilizer, cotton and seed industries were represented by NTEA in its early years. Other businesses, including commercial banks, have joined in subscribing to the association's program.

Over the years, NTEA has undertaken to persuade Congress to reduce the tax advantage enjoyed by cooperatives vis-a-vis private corporations. NTEA can therefore be considered as primarily a single-issue organization. However, one primary observation overrides our stated concern. We believe that it is imperative for the Congress to send a signal quickly to the financial markets that Congress is serious about reducing the expected fiscal year 1983 budget deficit. We believe that this is an undertaking which transcends traditional election year politics.

Although NTEA does not pretend to advance the entire solution to the deficit-interest rate problem facing U.S. taxpayers, we do believe that a tax policy neutral in its incidence and effects is highly desirable. As one step towards achieving this tax policy, NTEA advocates the elimination of the special cooperative corporation tax privileges as outlined in IRC Section 521 and Subchapter T of the Internal Revenue Code. The Congressional Budget Office has estimated that the loss of federal revenue, the "tax expenditure," due to these provisions is $670 million in fiscal year 1983.

This taxation proposal has not been addressed by the present administration in its budget recommendations. It has, however, been the subject of controversy, hearings, proposed legislation and Treasury rulings almost continuously since 1947.

The cooperative business in the United States is today Big Business in every way—except for tax status. Seven cooperative corporations now qualify among the Fortune magazine list of the 500 largest U.S. industrial corporations. Three cooperatives listed assets in 1980 of at least $1 billion. Farmer cooperative corporations had combined business volume in 1979 of $56.3 billion. Despite all of this, cooperative corporations pay virtually no federal corporate income tax.

Cooperatives pay such low taxes because, unlike their competitors, a tax is not levied on any profits which the cooperative returns or allocates to its owners. This tax treatment is essentially a deduction from corporate income tax liability for dividend allocations. Since most cooperative earnings go into refunds to owners, the income taxes paid by co-ops are very small. Generally, the co-op effective tax rate is below 10 percent.

Additionally, present law enables cooperatives to generate significant amounts of untaxed earnings for expansion of their business, an advantage not enjoyed by private-investor owned businesses. This occurs because present tax law requires that only 20 percent of the earnings allocation be in cash. The balance of the co-op profit is often returned to the patron in certificate form—bearing no interest. Allowing a deduction from corporate tax liability for dividends not paid in cash results in a substantial pool of tax-free funds for capital expansion. Although many firms would prefer this system of taxation, all object when only a limited few are so favorably treated.

In general, what we suggest is to tax the cooperative corporations on the same basis as privately-owned businesses and to treat co-op dividends in the same way that the dividends of ordinary businesses are treated. The right of cooperative corporations to exist and to grow unaided by federal tax subsidies is neither involved nor questioned by our proposal.

Thank you.

Sincerely,

RAY M. STROUPE.

STATEMENT OF THE NATIONAL TOOLING & MACHINING ASSOCIATION

Mr. Chairman and members of the committee: The members of the National Tooling & Machining Association are manufacturers and small businessmen. The average size of the 12,000 to 14,000 businesses in this industry is 26 employees. The importance of this industry is that it literally provides the means of all manufacturing production. Before any product can be manufactured, our members must provide the tooling, dies, molds, jigs, fixtures, gages, automated machines, and precision production parts necessary for mass-production.

The Congress and the administration are facing some very difficult choices. Despite significant reductions attained in Federal spending and the rate of inflation, our country currently faces high interest rates, high unemployment, and projected federal deficits of enormous magnitude. The decision we face is whether to live with the deficits or try to reduce them by either further cutting spending, increasing taxes, or both.

We believe that the federal deficit must be reduced. Deficit spending results in higher interest rates as the Federal Government competes with the private sector for available money.

High interest rates are having the most telling effect on small businesses. These businesses lack the ability to provide their own financing through the issuance of corporate bonds and they find that they must pay more than the prime rate for business expansion loans. High interest rates undermine the confidence both individuals and businessmen have in our country's ability to return to robust economic health. Resulting negative expectations in terms of future Federal deficits and their effect on interest rates further compounds the problem.

These factors point to the need to reduce the Federal deficit to a more reasonable level. There is no magic number, but we would suggest that a fiscal 1983 deficit of $50 billion or less, with further reductions in ensuing years, might be enough to reduce competition in the loan markets and instill a greater confidence in both individuals and the business community.

Of concern to all of us is how these deficit reductions are to take place. We beleive the reductions will have to come mostly from further budget reductions. On the tax side, we would suggest that you hold inviolate recent changes in depreciation rates, corporate taxes, and estate taxes. On the budget side, we would suggest that no area be held inviolate but that our defense budget not be cut until every last penny has been squeezed out of other budgets.

There are many possible budget options available in the February 1982 CBO publication "Reducing the Federal Deficit: Strategies and Options." Among some of the proposals that merit further consideration, and the revenue figures associated with them, are:

Budget reductions which would reduce deficit, fiscal year 1983 [1]

	Billions
Make States pay 20 percent of food stamp costs	$2.2
Reduce COLA for social security from 100 percent to 67 percent of CPI	5.2
Raise medicare premium (physician segment)	3.7
Raise medicare premium (coinsurance payment—hospital services)	1.9
Eliminate nonmortgage consumer interest payment deduction	1.9
$0.50 per barrel energy tax	2.9
Medicare beneficiaries to pay 10 percent of patient's first month deductible	1.1
Tax employees on employer-paid health insurance (income and payroll)	2.6
Cover new Government employees under social security	.3
Eliminate deductibility of State and local sales taxes	.8
Tax Federal employees for medicare	.7

[1] Assumes proportionate yearly savings for multiyear proposals.

We believe that significant additional budget savings could be achieved by reducing the COLA on Federal pensions and by prohibiting double and triple dipping on both social security and Federal pensions. Reforms in depreciation rates, corporate tax rates, and estate taxes should not be made because we continue to feel that these taxes will spur productivity and enable this country to again become competitive both domestically and internationally. We agree with the administration that these reforms are necessary and will work.

Those who have decried these reforms as unsuccessful because there has not been a major increase in business investment in the short time the law has been in effect have a misunderstanding of the business investment process and the current environment. Major corporations make their investment decisions on a long-term basis, very often in a planning process of five years. These plans can be modified, of course, but it can still easily take two years from the moment of decision to the purchase and installation of equipment and facilities resulting from such a decision. Small businesses can be, and are, much more flexibile in terms of investment decisions. The things holding small businesses back at the moment are consumer demand and interest rates. Interest rates are so high that they discourage consumers from spending. The resulting soft demand combined with the effect of the same interest rates on small businesses has temporarily negated the incentive of the recent tax cut. Reducing the Federal deficit will lick the interest rate problem. We are confident that there will then be increased consumer spending and major investment by all segments of the business community.

We suggest that deficit reductions be achieved primarily through further budget cuts. In modifying business taxes, we suggest that they be changed so as to have the least impact on the small business community. There are several reasons for this request. First of all, small businesses have been the hardest hit by the current recession, as attested to by the recent alarming increases in bankruptcy in this sector. Secondly, small businesses have the greatest capacity to lead the country out of the recession. Their investment and hiring decisions can be made and implemented very

quickly. Thirdly, small businesses can solve the problem of unemployment as they help with economic recovery. Small businesses have been credited with creating as many as 90 percent of all new jobs. These new jobs simultaneously reduce Federal transfer payments and expand the tax base.

It is with deep regret that we must conclude that the majority of the administration's tax proposals, while admirable in intent with respect to the Federal deficit, are not appropriate. Enactment of completed contract proposals will result in a law with complicated rules as well as higher prices since businesses will adjust prices to reflect the change in cash flow created by earlier tax payments. Nor is a corporate minimum tax a good idea, for businesses use profits for investment and job creation. A corporate minimum tax without a significant profit exemption of $100,000 or more would hurt small businesses, already battered by the recession and always in need of capital, the most.

We believe that industrial development bonds and industrial revenue bonds can be useful tools encourage businesses to come into an area and create jobs, but we also believe that they should be directed to businesses that would otherwise be unable to move into the area and to businesses that would provide the most jobs. In many States, small companies, who would otherwise be unable to afford plant expansion or major equipment purchases, are denied access to the bonds because of regulations pertaining to umbrella bonds. We suspect that restructuring the law in this area could simultaneously make this financing tool more available to small businesses, eliminate past abuses, and perhaps generate some revenues as well. The answer is not to force users of industrial development bonds to a straight line depreciation system, which negates most of their incentive, but to restructure the eligibility requirements so they go to the most appropriate users. One area that might be considered for a tax increase, since it would be evenly distributed among the business community and individuals, is a significant fee on imported oil or a tax on gasoline. This is a large enough tax base that a small percentage could provide many billions in revenue.

It is important that none of us take too narrow a view on the current economic situation. Tax policy can be adjusted not only to bring more Federal revenues necessary under present circumstances, but also to provide additional stimulus for economic recovery. Particular tax measures which can spur increased employment will expand the tax base and aid economic recovery.

Our research has revealed that there are significant numbers of openings for high-paying jobs in our industry at this moment. A census of our membership made in September 1981 and projected for our entire industry revealed a demand for 31,772 skilled workers, even under current economic conditions. These are substantial jobs, jobs which require four years of training and jobs which can easily pay in excess of $30,000 per year. Labor Department data and our contract with other industry groups suggests that there is a direct correlation between the job openings and the level of skill required and the typical size of the business. The higher the level of skill required and the smaller the typical company, the greater the shortage. We believe these shortages exist because the cost of training the highly skilled is very high and because small businesses typically lack the capital necessary to train. Federally funded training programs and incentives, such as the targeted jobs tax credits, have had only limited impact on the problem. This is because the social objective incorporated in the former have restricted access to the types of candidates needed for highly skilled jobs. The same holds true for the latter which is also further limited by the amount of the tax credit. To train someone for a highly skilled job costs far more than to train someone for a semi-skilled job. For example, the average investment per worker in our industry is $40,000 to $60,000. Productivity is also lost in the training process as our most highly skilled journeymen take productive time to work side-by-side with apprentices. The targeted jobs tax credit is probably a more than adequate incentive for many job categories but it is not an effective incentive for training the highly skilled because of the costs involved.

At first blush, it might seem that this is a problem only for those few specialized industries requiring highly skilled workers. It is, in fact, a problem for the entire country. Our industry, the high tech electronics industry, and others like it, are essential to the entire manufacturing community and to our defense industrial base. No major defense system and no major manufacturing endeavor can be carried forward without the skilled labor provided by this industry.

What we fear is that industries like ours, already short of skilled labor, will be unable to satisfy the demands of defense production resulting from the expanded military budget. We also fear that competition for these same skills will result when economic recovery begins in the private sector. With a four-year training period re-

quired to produce a journeyman, we are already behind the probable cycle of business recovery.

Congressman Don Bailey has introduced legislation which would address this problem. His solution is a highly specialized tax credit limited only to areas where there are significant shortages of highly skilled labor which are essential to the national defense. The Secretary of Labor and/or the Secretary of Defense would be empowered to certify these skills as essential and in short supply. Only then, and only if there was a significant shortage of the skilled labor, would training of these skills be eligible for the tax credit. This credit would be closely tied to the true cost of training—amounting to 50 percent of first year's wages and 30 percent of second year's wages. There would be no tax credits in the third or fourth years of training because the workers would be making a positive contribution by the end of the second year.

We feel that the critical industry Reindustrialization Tax Act, H.R. 3752, is in the best interest of the country and is also affordable even under present economic circumstances. It has also been introduced in the Senate as S. 1813. Our preliminary estimates of the revenue impact would be about $300 million the first year using a static economic model. The actual impact would be far less when the feedback effects of a dynamic model were factored in. We are in the process of producing such an econometric model and will be glad to share the results with this committee. If the resulting figures are within a reasonable range, we strongly urge that this legislation become part of this year's tax package.

Thank you.

STATEMENT OF DANIEL CARAPELLUCCI, PRESIDENT, THE NATIONAL UTILITY CONTRACTORS ASSOCIATION

Mr. Chairman and Members of the Committee, on behalf of the 2,500 utility contracting companies comprising the National Utility Contractors Association (NUCA), I implore you to make no changes in the completed contract method of accounting as it applies to the construction industry.

The completed contract method has played an integral role in the establishment and growth of this nation's construction industry since its implementation in 1918. This tax accounting procedure enables a contractor to defer paying taxes on income earned from a multi-year contract until that contract has been completed and accepted.

Due to the unique nature of the construction industry, this method of accounting represents the most practical and efficient tax procedure available. NUCA is the largest association in the United States representing contractors involved in constructing wastewater treatment projects, including pipelines, interceptors and sewage treatment plants.

When a utility contractor is awarded a construction project, he undertakes inherent risks associated with few other industries. The contractor works at a different site for each project—a site not owned or controlled by the contractor. Varying climate and soil conditions often add unforeseen costs to the project that must usually be absorbed by the contractor. Nearly all utility construction contracts contain owner retainage provisions, usually a percentage of the contract's price and in most cases exceeding the total estimated profit from the contract. Retainages are often used for corrections after project completion and, in all cases, retainage is not released to the contractor until after project completion.

Each of these factors translates into one indisputable fact: The profit to be earned on a construction project is impossible to determine until the project is completed and retainage received.

Another vital element in our argument against changes in the completed contract method of accounting involves financing. The ability to defer taxes until project completion enables a contractor to make full use of interim contract proceeds, providing him with a vital source of working capital. This factor has been perhaps the major catalyst behind the growth of the construction industry over the past sixty years. This working capital is used by contractors in every day business operations. Any plan to restrict this revenue source by imposing a tax on interim contract proceeds would surely result in both a reduction in business operations and a significant number of company closures.

Obviously, denying a contractor this source of working capital would have a two-fold negative impact: 1) Many businesses would be forced to compete for capital through public lending institutions, where money is already scarce and interest rates prohibitive. This increased competition for loans would only lead to even higher borrowing rates. 2) Company closures would further exacerbate an already

battered American economy. Companies are closing their doors at an alarming rate, and eliminating the completed contract method would undoubtedly result in significant unemployment in an industry now experiencing a jobless rate in the 20 percent range.

Indications are that the Reagan administration did not intend to single-out the use of this accounting method by the construction industry.

Rather, the administration's changes are directed toward defense contractors and the aerospace industry, which engage in extended duration contracts covering ten to twenty years. Extended duration contracts are simply non-existent in the construction industry; therefore, we should not be unjustly penalized.

While the administration intends to eliminate the completed contract method as a means of raising revenue for the federal treasury, the bottom line is that the total amount of revenue raised through the yearly payment of taxes on the contract would remain the same under the President's plan. For example, under the completed contract method as it now exists, a company involved in a three-year contract would owe $30,000 in federal tax after the contract was completed. Under the administration's plan, the contractor would owe $10,000 in each of the three years of the contract's duration. The sum total of tax owed over the three-year period remains indentical.

In summary, I reiterate to the committee the vital importance of this tax accounting method to the utility contractors and the entire construction industry. Should the President take steps to enact his proposal, the Congress of the United States must take the necessary preventive actions to preserve this accounting procedure.

Our message to you is loud and clear: No changes in the completed contract method of accounting.

STATE OF NEW JERSEY,
DEPARTMENT OF THE TREASURY,
April 14, 1982.

Hon. DANIEL ROSTENKOWSKI,
Chairman, House Ways and Means Committee,
Washington, D.C.

DEAR CHAIRMAN ROSTENKOWSKI: We are pleased to submit this testimony on the President's tax proposals and the miscellaneous tax bill which are being reviewed by your committee. New Jersey appreciates the opportunity to participate in the review of these proposed revisions.

Most of our testimony concerns the proposed changes in the use of Industrial Development Bonds, Mortgage Revenue Bonds and Industrial Revenue Bonds. New Jersey's experience with these development tools is quite extensive and the state has carefully developed rigorous procedures to insure that the public interest is protected in this area. The use of tax exempt bonds in New Jersey has been of invaluable worth to this state and its citizens; New Jersey authorities are among the largest users of tax exempt bonds and the state's Economic Development Authority is the single largest issuer of industrial development bonds in the country. It is because many of the federal administration's proposals adversely affect the use of tax exempt bonds that New Jersey is especially concerned about testimony given before this committee.

We are confident that the criteria established by New Jersey authorities and agencies concerning the use of tax exempt bonds are sufficient to protect the public interest. Consequently, we offer the New Jersey experience to this committee as a model by which the administration's proposals may be evaluated. New Jersey has been successful in its attempts to operate productive tax exempt bond programs which guard against the abuses the administration and Congress are trying to eliminate.

New Jersey is convinced that several proposals which have been advanced to curb the use of tax exempt bonds will very seriously impair the ability of some of our public agencies to accomplish their public purposes. Moreover, because of the close relationship between the federal government and the state governments, we believe that the objectives of the federal government, as revealed in these prospective revisions, will not be met. The curtailment of tax-exempt financing will in many cases be counterproductive to both state and federal interests.

We commend the committee for its work on what is obviously a most difficult legislative agenda. We share the goals of the committee. It is our strong desire to see the federal deficit diminished and tax equity maintained. This testimony is offered to assist the committee in its deliberations so that those enterprises made possible

by tax exempt bonds will be able to continue producing jobs, investment and revenue to the benefit of New Jersey and the Federal government.

Sincerely,

KENNETH R. BIEDERMAN,
State Treasurer.

STATEMENT OF KENNETH BIEDERMAN, STATE TREASURER OF NEW JERSEY

The major proposals concerning tax exempt bonds and New Jersey's responses are summarized as follows:

(1) To insure that tax-exempt obligations issued for private activities serve valid public purposes, the obligations must be approved (after a public hearing by the highest elected official or legislative body of the jurisdiction in which the project is to be located or by a voter referendum).

All tax exempt obligations issued for private activities in New Jersey are already approved by the highest elected official in New Jersey. In the case of the Economic Development Authority, the New Jersey Health Care Financing Authority, the New Jersey Health Care Financing Authority, the New Jersey Higher Education Assistance Authority, the Mortgage Finance Agency, the Housing Finance Agency, and the New Jersey Educational Facilities Authority, all financial activities are approved by the Governor. The Economic Development Authority is the sole issuer of IDB's in the state and its activities are closely scrutinized by the Governor who approved the minutes of the Authority and by the State Treasurer who is a voting member of the Authority.

New Jersey strongly endorses this practice.

(2) For bonds issued after December 31, 1985, the governmental unit must make a financial contribution or commitment to the project. The contribution may be a direct grant, tax abatement, or provision of additional services having a value of at least one percent of the face amount of the bonds. The financial commitment may take the form of a general obligation of the governmental unit, or primary guarantee or insurance of the bonds.

The New Jersey State Constitution specifically precludes the State government from either directly or indirectly pledging the full faith and credit of the State without a statewide, public referendum. This would preclude any sort of legal guarantee of IDB's by the State or would preclude the use of IDB's.

Though the concept of copayment is appreciated, contributions in the amount of 1 percent of the face value of the bonds certainly makes it more difficult for those public authorities which are serving the public interest to accomplish their public purpose, and, in the case of New Jersey is perhaps superfluous.

Public authorities are already taking financial risks, particularly in the area of low-cost housing and student loans. It would be counter-productive to both State and federal interests to place additional burdens on housing agencies such as New Jersey's Housing Finance Agency and Mortgage Finance Agency. The Housing Finance Agency already has moral commitment as does the south Jersey Port Authority.

Efforts of the New Jersey Educational Facilities Authority and the New Jersey Health Care Facilities Financing Authority would both suffer if contributions would be required. Both educational costs and health care costs would be directly affected by the contribution requirement. Because of federal subsidies in this area, it appears to be the case that no cost savings would be realized in any case.

Letters of credit should suffice for assurance that the public interest will be protected.

New Jersey believes this proposal to be counterproductive to both State and Federal interests.

To require the copayment of all states is to doubly penalize those states which have already assured a fiscally prudent position.

(3) Depreciable assets financed with tax-exempt bonds must be written off using the straight-line method over the extended cost recovery period used for computing earnings and profits and will therefore not be eligible for the accelerated cost recovery system (ACRS) enunciated in the 1981 Tax Act.

It is clear that a choice between ACRS and IDGs will work to the distinct disadvantage of IDBs. Because IDBs are so important to the public and private sectors in New Jersey (and nationally), it is important that business not be forced to choose between these two methods of taxation.

The President's Program for Economic Recovery recognized the nature of depreciation in an inflationary environment and appropriately established the accelerated cost recovery system. The concept of an IDB recognize the need for government involvement in economic development when there is a threshold of return that must

be overcome before industry will locate. Thus, the use of ACRS should not be allowed to preclude the use of IDBs because each of these mechanisms in designed to abate on distinctly differing problems. IDBs are specifically designed as an inducement to facilitate new investment; ACRS is predicated on the grounds of adequately accounting for depreciation in the existing economic environment.

Such a choice between ACRS and IDBs will not only dry up funds for investment in areas designated by the State as especially deserving but will also deal a near-fatal blow to public agencies which are in need of the tax advantages of IDBs to compete in the market for investment dollars.

New Jersey strongly opposes the proposal which requires IDBs beneficiaries to use straight-line method of accounting depreciation.

(4) Small issue IDBs will be limited to small businesses that have no more than $20 million of capital expenditures during a six-year period and have no more than $10 million of industrial devlelopment bonds outstanding immediately after the issue. Federal objectives can be accomplished by limiting IDB outstanding investment in specific communities to $10 million. If unnecessary limits are placed on specific firms, this will only preclude these firms from expanding, which is one of the purposes of issuing IDBs in the first place.

Federal concerns are alleviated by present New Jersey policy of scrutinizing developer financial data to insure that only those developments which may be attributable to the acquisition of IDBs are approved.

To restrict capital investment to $20 million during a six-year period (three years prior and three years subsequent) surrounding the acquisition of an IDB will definitely be detrimental to the IDB program with little or no corresponding benefit to federal or state governmental agencies. Many small businesses will be deterred from investing with IDBs.

New Jersey supports a $10 million investment limit within specified areas, but opposes a $20 million capital investment limit (during a six-year period) and a limit on outstanding IDBs.

(5) The bonds must be in registered form and information must be reported to the IRS upon the issuance of the bonds.

New Jersey supports a requirement for registration forms and reports to federal agencies. However, it should be noted that registration restricts marketability and may be an onerous burden to many potential bond buyers.

(6) Restrictions will be placed on the ability of the issuers to earn arbitrage profits.

Further arbitrage restrictions will only hurt public agencies in their attempts to recoup bond costs and operating expenses.

Presently, several New Jersey agencies, including the Housing Finance Authority require present arbitrage earnings to operate.

The part of this proposal which would affect reserve funds would cause serious problems with the financial strategy worked out with regard to construction projects. The timing and amount of bond fund drawdowns cannot coincide exactly with investments: earnings on some construction funds make up for losses on others.

Recent market instability has provided arbitrage restrictions. Further government restrictions would be extremely problematic.

New Jersey does not support more stringent arbitrage restrictions because they would be counterproductive to the stated public purposes of the State's financing authorities.

II. IMPACT OF TAX PROPOSALS ON SPECIFIC AGENCIES

New Jersey educational facilities authority

The proposed changes would provide for extremely restrictive and cumbersome procedures relating to the issuance of tax-exempt securities for public institutions of higher education, and more so for independent colleges and universities in New Jersey.

EFA bonds are revenue bonds issued for public purposes, not private purposes, thus, they should not be considered industrial revenue bonds. Bonds issued to support projects on public college campuses would appear to continue to be allowed since all public colleges and universities in New Jersey are governmental units, or agencies of the State. While independent colleges and universities may be considered public, i.e., the education of citizens of the State, hence, bonds issued for these institutions should not be labeled as private purpose. Not incidentially, all private institutions in the State are already eligible "501 (c) (3)" entities. Further, the "501 (c) (3)" colleges and universities do not apply the proceeds of issues of bonds to the conduct of trade or business.

EFA bonds are approved for issuance by the highest elected official, the Governor.

EFA is an independent governmental agency, receiving no financial support from the State of New Jersey. To require a contribution of the Authority to the project is impossible since such monies are not at hand. The Authority Act precludes the use of State appropriations in the amortization of a bond issue and this point was explored and upheld when the New Jersey Supreme Court heard arguments testing the statute. The Authority's bond resolutions provide for registration of bonds at the option of the holder. Since the bonds are tax-exempt, mandatory registration and reporting to IRS would seem to accomplish no real purpose.

New Jersey health care facilities financing authority

The enactment of these proposals would be extremely detrimental to New Jersey's health care facilities and are not justified by the facts. The proposals would only serve to increase costs for all health care payors, including Medicare and Medicaid while severely restricting the availability of captial for health care projects which have been justified and approved through a stringent process of public review.

Tax-exempt financing for non-profit hospitals is needed and justified by the nature of the institutions receiving the benefit, by the beneficial public purposes of the investments it assists, and by other circumstances unique to hospitals;

1. Non-profit hospitals are an essential part of our interdependent health care system, impairing their ability to accomplish the important public purpose of maintaining public health will adversely affect public hospitals and other health care institutions;

2. Tax-exempt financing assists in providing capital needed to renovate old facilities, to replace obsolete equipment, to convert facilities to new uses in response to changing circumstances, and to reduce interest expenses by refinancing existing debt;

3. Non-profit hospitals need federal assistance to raise captial because their traditional sources of captial are becoming increasingly unavailable—in large measure because of federal government actions (e.g., changes in tax laws, all-savers, etc.);

4. Any effort to diminish health care costs, by increasing competition or otherwise, depends on a community of strong, well capitalized, non-profit hospitals.

There is no evidence that tax exempt hospital financing causes "overbedding" as some critics suggest. Funds raised from such financing are seldom used to increase bed capacity. This is demonstrably the case in New Jersey.

New Jersey was the fourth largest issuer of tax-exempt health care bonds in 1981 according to statistics published in The Bond Buyer, and accounted for about 9 percent of all hospital public financings. The New Jersey Health Care Facilities Financing Authority is the sole state issuer of tax-exempt bonds for private non-profit hospitals and accounted for all but one of New Jersey's projects since the State has very few proprietary hospitals. By law, the New Jersey Health Care Facilities Financing Authority works closely within the framework of the State's health care system, and, in its ten year history, during which time it has issued more than $1 billion in tax exempt bonds for the State's health care facilities, it has earned a national reputation as a careful and responsible issuer.

New Jersey's hospitals will have substantial capital needs in the next decade to maintain and renovate many aging physical facilities, to meet life safety and other accreditation requirements, and to keep pace with rapidly changing medical technology. We are not talking about expanding bed capacity, but simply maintaining and consolidating existing facilities. At a minimum, the current Treasury proposal will result in a more cumbersome and expensive process of raising capital. Any such additional costs (and these are substantial) will offset Treasury revenue gains, since virtually all hospitals issuing tax exempt bonds receive Medicare or Medicaid reimbursement payments. State governments, which share in Medicaid costs would be impacted, as would all other hospital payors. Moreover, if hospitals are forced to find alternatives to long term, tax exempt financing, these would almost surely be of shorter duration and costlier than current arrangements, thereby resulting in an even greater strain being placed on already hard pressed health care payors.

In summation, any desire by Treasury for assurance that tax exempt financing is used for genuinely public purposes can be given without the extra financial and political commitments by State and local governments that the Treasury proposal contemplates. In the case of health care institutions especially, the nature and function of the institutions, the existing controls on their capital projects and the existing financial commitments of state and local governments to these institutions makes the addition of any further requirements not only unnecessary but also extremely difficult to achieve in practice.

New Jersey higher education assistance authority

Student loans, when compared with other types of commercial loans, are considered relatively high risk loans since repayment of these loans is subject to the economic and employment conditions prevalent at the time when the student borrower completes school, and to other factors which are not determinable at the time the loans are made. To counter this risk, the federal government, through state agencies, offers lenders a 100 percent guarantee of repayment; quarterly interest subsidy payments at a fixed rate; and a special allowance tied to Treasury Bill rates which makes this portfolio competitive with other loans. As a result, it has become a rare phenomenon in New Jersey for an eligible student not to be able to procure a Guaranteed Student Loan (GSL) to attend the school of his choice. The New Jersey Higher Education Assistance Authority also operates a loan program of last resort to accommodate those students unable to find a willing lender. Last year only 12 of these loans were needed, compared to 140,000 loans made through commercial lending sources.

New Jersey, which has had statutory authorization to enter the bond market since 1969, has never had to exercise this option because private enterprise has met the challenge to provide student loan capital and the NJHEAA has guaranteed more than $1.5 billion over the last two decades. With changing economics brought about by record high interest rates and the uncertainty of federal support levels for the GSL Program, the strong possibility exists that this trend may come to an abrupt halt. It will be very difficult for the student to find a willing lender under proposed legislation and many could be forced to forego pursuit of postsecondary education because of a lack of adequate funds.

Therefore, more than ever before, state agencies will be compelled to become lenders of last resort to take up the slack created by lenders who withdraw from the program. Since agencies are not-for-profit and must sustain the costs of their operations, the tax-exempt revenue bond remains the only viable means of financing this program. Since January 1980, more than $950 million has been issued in tax-exempt bonds for student loans in 15 states. The Congress has already established a provision to effect federal cost savings by limiting the special allowance paid on loans funded in this manner to one half the normal rate. Escalating educational costs, coupled with decreasing financial assistance (grants and loans) from federal and state sources, mean that student loan programs are needed and will be in demand. Tax-exempt bonds seem to be the most logical vehicle to underwrite this need.

The effects of the proposed conditions which limit tax exemption are as follows with regard to New Jersey student loans:

(1) The requirement of elected official approval for bonding is already provided for in New Jersey Statute (18A:72-10.1): "the Authority shall furnish to the Governor a certified copy of the minutes of the meeting at which said bonds are sold and awarded forthwith upon the taking of such action and the Governor shall indicate his approval or disapproval of such action." Authority meetings are open to the public and advertised in compliance with the Open Public Meetings Act. Special meetings designated solely for the issuance of bonds would be held and advertised as other regularly scheduled meetings, so there appears to be little or no impact from this provision.

(2) Under present legislation, the State of New Jersey does not designate bonds for student loans as general obligations. With regard to the proposed condition calling for governmental commitment or contribution, the New Jersey Statute (18A:72-10.13) contains a Pledge of State which was designed to satisfy the needs of investment bankers. If this should not be satisfactory in today's market, then the one percent face amount of the bond issue could be paid from the loan reserve fund, but replenishment to the funds would then be sought from future loan borrowers by increasing the fee currently imposed. This provision need not take place until December 31, 1985, thus extending a period of 3½ years to prepare.

Economic development authority

With this presentation is enclosed a list of 1981 New Jersey Economic Development Authority closed IDB projects, and a copy of the Authority's IDB targeting regulations. The New Jersey Economic Development Authority is the sole issuer of IDB's in New Jersey and, to the best of our knowledge, the largest single issuer in the United States.

The New Jersey Economic Development Authority was created in 1974 as an independent authority of state government to promote jobs and business investment in the state. In the early years of the Authority the New Jersey economy suffered the highest unemployment rate in the nation and an economic recession of severe pro-

portions. At that time the Authority issued IDB's on a broader basis than is now the case. As the state economy began to recover, the Authority realized that changes should be made in the use of IDB's in New Jersey, and accordingly in 1977 began to restrict their use.

The Authority's industrial development bond program since its inception can be related to over 63,000 operating jobs created or maintained, the creation of over 40,000 jobs in the construction field, and total private investment of nearly $3½ billion. In 1978 the Authority established a special unit to closely examine the job estimates provided at the time of application and compare these with actual jobs once the project is completed, and for follow-up periods thereafter. As a result, we believe its job figures are among the most carefully recorded and reported of any economic development program in the nation.

New Jersey recommends that the Congress retain existing tax exemptions on industrial development bonds. We make this recommendation based on our considerable experience which convinces us that the elimination of severe restriction of these bonds would seriously impede capital investment in key sectors of the U.S. economy in general and the economy of New Jersey in particular.

Nevertheless, we are sympathetic to Congressional and Administration concerns and objectives regarding IDB's and we feel the New Jersey IDB program is consistent with those aims. We further feel the New Jersey model could be applied on a national level to meet concerns regarding possible misuse of the bonds. As will be explained in Section 5 of this presentation, New Jersey restricts use of industrial development bonds on two bases, namely, (1) to economically distressed areas, and (2) to those business sectors which justify tax incentive financing in the particular structure of the New Jersey economy.

We support the following legislative positions:

1. Retain the present IRS Code provisions; eliminate IRS Revenue Ruling 81-216 prohibiting umbrella issues.
2. Allow private letters of credit for public offerings of umbrella bonds. Allow intra state umbrella bonds without restrictions.
3. National annual reporting.
4. Public hearing for each bond issued.
5. Each state to formulate and administer a targeting methodology subject to review by appropriate federal entity.
6. Retain the $10 million capital expenditure limit per community as an effective means of limiting IDB use.
7. Allow office building projects to use IDBs on a restricted basis.
8. Final approval of IDB financing by an elected official.

We oppose:

1. Mandating user choice between ACRS and the IDB.
2. Governmental guarantees or required state or local financial participation.
3. Federal administration of targeting.
4. State caps on IDB volume.
5. Limits on IDB use by size of total capital expenditures of user.

IDBs Used Mostly By Small and Medium Businesses

It is appropriate first to address the small and medium business consideration because these are by far the largest users of IDBs and those most in need of this type of business development financing.

The important fact which may be overlooked solely by federal treasury revenue considerations is that the small issue IDB program is a business development necessity for small and medium size businesses, as exemplified by New Jersey's experience.

In 1980, in New Jersey, 86 percent of all IDBs were related to businesses with less than $20 million in sales.

In 1980, in New Jersey, one in every five IDBs was related to firms with less than $1 million in sales.

In 1980, in New Jersey, 94 percent of all IDBs were related to firms with less than 200 employees.

In 1980, in New Jersey, 54 percent of all IDBs were related to firms with less than 50 employees.

We are now obtaining business size data for New Jersey's 1981 IDB program. While all the data are not yet available, sufficient information is in hand to indicate that the 1981 characteristics will be similar to those experienced in 1980.

Unfortunately, there are no similar statistics available for the entire national IDB program. In fact, there is a general paucity of reliable and essential information on

many characteristics of IDBs. However, because of the State of New Jersey is the third largest issuer of IDBs in the nation, it is fair to assume that the characteristics of New Jersey's program represent the national program or are very close to an average representation.

As an aside, we caution against enactment of far-reaching legislation without an adequate base of information. This could seriously suppress the nation's small business program and deter the very sector most in need of access to capital.

The purpose of the tax exempt small issue industrial development bond is to provide a capital investment stimulant. The IDB does so effectively and efficiently. The IDB offers businesses a significantly lower interest rate, recently averaging 65 to 75 percent of prime. Often this factor alone determines whether the firm will proceed with the investment. In addition, the presence of the incentive affects the timing and size of the investment. For small and medium businesses these considerations are crucial. Typically, not much financial leeway is available in this business size sector.

Economic growth, resiliency, and productivity lie for the most part in the small and medium size business sector. Therefore, we ask the members of the Senate Finance Committee to weigh very carefully the success and efficiency of the IDB program as a superior capital formation instrument in the small to medium size business sector, which is presently recognized to be the most in need of capital investment incentives.

IDB Volume and Market Effect

IDB volume is growing. However, rather than being regarded as an undesireable state of affairs, this should be recognized as a sign of the continued need to stimulate capital investment with this proven instrument.

The problems of the tax-exempt bond market are not due to the presence of IDBs or their growth in volume. Rather, the tax-exempt market difficulties are due to erratic interest rates, structural changes in the capital markets, and recent disenchantment with long-term fixed rate investments. This last factor, in turn, certainly is reflective of the disruptions caused by heavy U.S. Treasury borrowing. Furthermore, it is unwarranted to assume that the sudden disappearance of IDBs would result in an offsetting flow of funds into other tax exempt obligations. It is our experience that IDB funds are for "bank lending" and not for "bank investing." If IDBs were not available, the banks (who are the largest single investors in IDBs) would find alternative uses for these funds and not merely seek to place them in the tax free bond market. Eliminating IDBs would not significantly improve the municipal bond market.

Of course, we too would view with alarm a substantial increase in IDB use which falls into the category described in some sectors as "misuse." We agree that certain uses of the IDB should not be allowed. However, the time has come to allow each state a greater degree of determination and judgment in handling its economic affairs. The IDB is a perfect instrument for just such a policy. The IDB needs only general guidelines from the federal establishment in order to operate effectively as an economic instrument and at the same time remain within the bounds of sound national economic policy.

IDB or ACRS

It is in the public interest to achieve a sound economy by IDB and ACRS.

The IDB is essential in the small and medium size business sector to induce the decision to invest in the first place. ACRS is needed for the proper recovery of the costs of depreciable assets under today's business conditions—an essential ingredient for the nation's economy.

Independent studies that have been brought to our attention are consistent in establishing that if a business must choose between IDB and ACRS the choice will be for ACRS in a very large majority of cases. That is unfortunate, economically speaking.

Only if we remove obstacles to capital investment and encourage the future of production to recover costs on an accurate, economic basis can the nation's productive capacity grow and strengthen. We must do everything possible to encourage capital investments that are productive and economically sound. The measure of economic soundness of these investments does not lie in whether or not the federal treasury realizes enough revenue but rather goes to whether or not costs of replacement are adequately and accurately recovered in the course of business operations. ACRS does provide that realistic replacement capacity and accordingly we are fully in favor of ACRS.

It is important to emphasize that the economic justification for ACRS is the true cost of replacement, not whether the U.S. Treasury receives or does not receive sufficient revenue. It is imprudent to regard federal "losses" atttributable to ACRS as a proper economic consideration; the alleged revenue losses of ACRS is not the issue to be addressed.

What is the heart of this matter is whether or not the IDB is an effective capital formation and business development incentive. It is. The IDB over and over again has proven itself as an investment stimulant. With the IDB it is possible for business to undertake projects at a much lower cost than would be the case without the IDB. This very often is the primary or even sole determining factor as to whether the business will go forward with the project. In many cases before the New Jersey Economic Development Authority applicants and potential applicants have made it very clear that they cannot proceed with their project if they cannot finance it through the IDB. From our own experience, which is considerable, it is our conclusion that the vast majority of projects have been financed only because of the availability of the IDB.

It may be true that some projects might be built without IDB activity. However, it is our stated intention that only those firms which can demonstrate that the IDB is decisive in their determination to proceed with a development project be approved for funding.

Even if it were the case that a few projects would have proceeded without such funding, this is an acceptable cost for continuing a very effective program operating for the benefit of small and medium businesses which truly do require the IDB.

The proposed rule providing for the choice by business of the IDB or ACRS is counterproductive to the purposes of the Program for Economic Recovery. The paramount consideration for the Congress, so far as business development programs are concerned, is whether or not a small or medium business will be induced to undertake the project in the first place. That is where the focus of the nation's economic policy should lie. ACRS, meritorious as it may be, will not provide such an adequate initial incentive to invest in our present investment starved economy, particularly in the small and medium business sector.

The incentive failing of ACRS is that small and medium businesses need to use operating revenues for on-going business operations. Characteristically, owners and managers are reluctant to divert these essential cash flows for capital improvements. That is why ACRS is not an adequate investment incentive. If capital improvements invade too deeply these operating revenue flows then the business will draw away from possible investment, with a consequent loss of growth and expansion activities to the busines and to the economy.

That is why the policy of IDB and ACRS is the desired policy. The IDB provides the initial investment incentive and ACRS provides for proper replacement cost. The two together contribute to the desired effective incentive in the small and medium business sector.

To summarize this point, the question of IDB and ACRS should be measured in terms of its likely efficacy as a business development policy, and not in terms primarily as to whether or not there is an alleged federal revenue loss.

Alleged Revenue Loss

The assertions of revenue loss made by the Treasury do not warrant the elimination or curtailment of the IDB and ACRS policy. Many observers strongly disagree with the CBO and U.S. Treasury estimates of revenue loss. They contain assumptions and premises which are not warranted by the facts. The estimates of revenue loss we have seen:

(1) Erroneously assume all IDB projects will be built at a higher interest rate;

(2) Erroneously assume that IDB purchasers would otherwise fund the projects or a taxable basis;

(3) Do not adequately allow for revenue flow-back.

These invalid assumptions made it impossible to accept CBO or U.S. Treasury estimates as realistic.

For the greater majority of IDB projects the federal income tax paid by those employees whose jobs result from the financing and the corporate tax of the projects created more than overcame the commonly stated magnitude of revenue loss.

It had been stated for 1981 the U.S. Treasury has a $1 billion revenue loss due to the IDB. Our own calculations show that the federal revenue paid back by these IDB projects amounted to somewhere in the range of $3.4 billion to $5.7 billion for 1981. We think therefore the assertion of revenue loss due to the IDB should be

weighed against the actual federal revenue realized from the projects that have used the IDB.

In short, the IDB more than replenishes the revenues alleged to be lost.

"Misuse"

IDBs are not misused. At least, that is not the way to characterize the entirety of the IDB program.

New Jersey has been prudent in its judgments of what is an allowable IDB project and what is not an allowable IDB project. We run an extremely successful targeting program in New Jersey and we do not believe that those who are concerned about "misuse" of IDBs would hold that there are many, if any, such misuses in the New Jersey IDB program.

However, we recognize, and we ask this Committee to recognize, that the various states view their economic problems, their economic circumstances, and their economic requirements in different ways. The best way to curb possible "misuses" is to allow states on their own determination to judge what is allowable and what is not allowable within federal guidelines. There is no reason why each state could not provide an acceptable IDB program under such guidelines published by an appropriate federal entity.

New Jersey's IDB program is restricted to (a) distressed municipalities and (b) to manufacturing and industrial sectors, and to non-speculative, larger headquarter facilities (but within present IDB limits). Headquarter facilities are particularly important to New Jersey because of its location, the general trend to a service economy, and to help compensate for the loss of manufacturing businesses. There are certain other sectors for which bonds are issued, but these account for relatively few IDBs: research and development; private nursing homes; agriculture; other exempt activities under IRS Code 103, etc.

The New Jersey Economic Development Authority annually identifies distressed localities according to two formulas. The first is a state-aid formula called "Urban Air to Municipalities." The second is an index derived from statistics of unemployment, per capita income, and tax ratables. Many types of projects, but not all, are eligible in these distressed localities in New Jersey. Our list of such localities is much shorter than the UDAG list.

New Jersey also allows IDB activity in locations of natural or economic disasters, previously designated urban renewal zones, and for projects which employ a significant number of disadvantaged persons.

Projects eligible under our restictions must still pass a detailed application process which further examines the appropriateness of the project, the results of which are reviewed by senior staff. Each project is then presented for approval at a public hearing before a board consisting of five state Cabinet members and four public members.

Finally, each project approved by the Authority's board is subject to veto by the Governor.

New Jersey IDB projects are identified in detail in the Authority's annual public report.

Housing Finance Agency

Comments on the Mortgage Subsidy Bond Act—Multifamily housing

We appreciate the fact that there was a need to regulate the unrestricted use of mortgage revenue bonds which was taking place prior to the introduction of mortgage revenue bond legislation in 1979. Without corrective legislation, passed in 1980, the municipal bond market would have been overwhelmed by the volume of tax-exempt mortgage revenue bonds. However, the Mortgage Subsidy Bond Act of 1980, as finally enacted, included some provisions which makes it difficult to issue certain types of mortgage revenue bonds for multi-family housing. Some of these problems relating to the term of the bonds, and the income limit for those persons defined as low-income under the multi-family provisions, have been removed by the Senate amendments H.R. 4717, and we hope the House will soon accept the Senate amendments. Still, some problems remain with the Mortgage Subsidy Bond Act.

First, in requiring that at least 20 percent of the units in a multi-family development financed by tax-exempt bonds be available for persons of low and moderate income, as defined by the federal government, the Congress was assuming that some subsidy mechanism would exist to assist these low-income persons. Currently, however, the federal government is moving to eliminate the subsidies that have been available to low-income persons who choose to live in newly-constructed or substantially rehabilitated rental housing financed with mortgage revenue bonds. If the fed-

eral government is eliminating the source of funds that allow at least 20 percent of the units in a multi-family development to be set-aside for low-income persons, meeting specific income criteria, the Congress ought to eliminate the requirement altogether. Virtually all states, including New Jersey, have fixed income limits that restrict the tenancy in multi-family developments financed through tax-exempt bonds. These are the income limits that ought to apply, and not a federal standard which no longer has any resources to implement it. Some states may want to have substantially more than 20 percent of the units in its multi-family developments set-aside for low and moderate income people, but, whatever the choice, the states should have the authority to determine the appropriate percentage and establish the appropriate income limit.

Second, the current law is unclear on the matter of what happens to the 20 percent requirement for low-income persons once a mortgage loan has been paid off. The responsibility for guaranteeing the 20 percent requirement should cease when a mortgage loan made through mortgage revenue bond financing is fully amortized. Unless this requirement is clarified in regulations or by a statutory change, agencies could be in a position of being restricted from disposing of an unsound development and thus face serious potential financial hardship.

Comments on the industrial development bond proposal prepared by the Reagan administration

On February 26th, the Treasury department published an explanation of its revenue-raising proposal. The proposal includes restrictions on the use of tax-exempt financing for multi-family housing. We think it is ill-advised at this time to impose further restrictions on the use of industrial development bonds for multi-family housing. It is our recommendation that the proposal to restrict the use of tax-exempt bonds for multi-family housing be removed from the Administration's tax package. It is well known that there now exists a national housing crisis, with housing starts at their lowest level since World War II. In New Jersey there were only 814 units of low-income housing produced in the entire state for fiscal year 1981, and all of those were produced through tax-exempt mortgage revenue bonds sold by the State's Housing Finance Agency. The need for rental housing in New Jersey is documented by the most recent Housing Assistance Plans developed by all of the cities and urban counties in the state receiving federal Community Development Block Grant funding. These plans indicated that there was a need in fiscal year 1981 for over 24,000 units of newly-constructed and substantially rehabilitated rental housing for low and moderate income persons. Our State Housing Finance Agency has been the principal producer of this type of housing for over a decade, having financed more than 30,000 units through the use of tax-exempt financing. All of these units have benefitted low and moderate income individuals, approximately 90,000 persons, and were done without the onerous restrictions imposed by the Administration's recent proposal. Moreover, all of these units were financed without any federal insurance; the state agency assumed all of the risk for these developments.

With federal subsidies for new construction being eliminated, while the need for some expansion of the rental supply clearly exists, it is not sound public policy to impose additional restrictions on the use of multi-family mortgage revenue bonds. Tax-exempt financing for multi-family housing is accepted in the marketplace and is available now to reduce the high unemployment in the construction industry and give an immediate boost to our nation's economy.

It cannot be argued that the volume of mortgage revenue bonds for multi-family housing is increasing. In fact, the opposite is true. As the federal subsidies to support tax-exempt financing have decreased, so has the volume. In 1978 there were $5.6 billion in multi-family bonds issued; in 1981 this figure declined to $3.7 billion. A workable, efficient mechanism is now in place for producing multi-family housing: the use of multi-family tax-exempt mortgage revenue bonds. Across the country, the use of these bond proceeds has benefitted low and moderate income persons. Facing national rental housing needs of over 400,000 units a year, and an Administration proposal which eliminates federal subsidies for new construction and substantial rehabilitation, we must support the continuation of tax-exempt financing for multi-family housing and oppose restrictions which threaten the viability of this widely-successful production tool.

Probably the most damaging proposal would eliminate the use of accelerated depreciation, where tax-exempt multi-family bonds were used to finance the development. Potential investors and developers depend upon the tax advantages provided by accelerated depreciation, also known as double declining balance depreciation. This is an important carrot that historically has attracted capital into low and mod-

erate income housing developments. Without the continuation of accelerated depreciation, the number of investors in low-income housing will shrink dramatically, putting almost a complete halt to multi-family production.

In New Jersey, we have had many developments convert from non-profit to limited dividend ownership through a carefully-controlled syndication process. Through syndications, additional project revenues help achieve project feasibility; provide additional security for the bonds; and finally assist both project sponsors and localities in carrying out needed community development activities. These syndications have been a great benefit to the developments, but without accelerated depreciation available to the new owners, these syndications would not occur.

High risks are inherent in investments in low and moderate income housing, and accelerated depreciation benefits offer potential investors the only real financial incentive for putting their capital into housing production. Accelerated depreciation must be preserved if we are to see a continuation of multi-family housing production.

Another section of the proposal that would have serious negative consequences are the restrictions placed upon both investment earnings on reserve funds established with tax-exempt proceeds, and the undisbursed mortgage proceeds held during the construction period. It must be emphasized that the multi-family mortgage revenue bonds issued by the New Jersey Housing Finance Agency are self-insured. The bonds are secured by mortgages backed by a moral pledge from the State of New Jersey. The Agency holds more than $1 billion in mortgages on high-risk housing projects for low and moderate income persons. The positive arbitrage earnings on reserve funds and funds held during construction have been essential to cover mortgage arrearages on several of the Agency's developments. Even with these investment earnings, the Agency has on occasion had to use its own administrative funds and funds not advanced during construction remain solely for the benefit of the project, to assure that debt service payments can be made. These funds do not flow to the Agency, but act as a vital insurance fund helping secure the agency's bonds.

While the Treasury proposal aims at restricting positive arbitrage during construction, issuing agencies over the last two years have had to struggle just to break even and avoid negative arbitgage. Interest rates being what they have been have prevented positive arbitrage on construction funds. Restricting arbitrage earnings on construction funds has already been regulated by the marketplace.

There are other reasons why restrictions on investment earnings from construction funds are harmful. The timing of debt service payments for bonds, which generally comes twice a year, cannot possibly coincide with the great variety of investments made on the undisbursed proceeds in a bond issue. It is the positive earnings on some of these investments that allows debt service payments to be made. A second problem with imposing restrictions on earnings during the construction period concerns the changing nature of the construction drawdown schedule. When an agency sells a bond issue, it makes certain projections on how the various projects in the issue will drawdown the bond proceeds. It develops an investment strategy which coincides with these drawdowns. In practice, it is impossible to predict with precision what the drawdown will be for all the projects in a bond issue. The positive earnings realized on some of the construction funds typically offsets losses that result from other projects drawing down funds either earlier or later than anticipated. There is a need for yield flexibility during the construction cycle, for without this flexibility the Agency could suffer net losses during the construction period.

One last point of concern should also be mentioned. The multi-family proposal requires issuers to make a contribution equal to 1 percent of the face amount of the bonds after 1985. In this era of fiscal austerity, raising this money could be a problem for some states. One also wonders why states which are assuming all of the risk in financing low and moderate income housing should be required to make an additional 1 percent contribution. If this provision in the Administration's proposal remains, it should be clear that the states are given credit for tax abatement resolutions approved by the municipalities where multi-family developments will be located.

Mortgage Finance Agency Mortgage Subsidy Bond Tax Act—Single-Family Housing

New Jersey strongly recommends the following amendments to the Mortgage Subsidy Bond Tax Act of 1980.

Arbitrage restrictions should be increased slightly from 1 percent to 1.25 percent. The 1 percent is unworkable. In New Jersey, to do a $36 million bond issue, a $1.1 million cash infusion by the Agency is required.

The targeted areas should be expanded to include: Energy impacted areas; areas of chronic housing capital shortage at affordable rates.

The first-time homebuyer provision should be amended to permit an exemption for substandard housing previously owned.

Permit financing of 1-4 unit owner-occupied property conversions and additions. Current single-family home improvement and rehabilitation loan provisions appear to prohibit making loans to owners (particularly elderly) of large, energy inefficient homes for purposes of converting the homes into 1-4 unit, owner-occupied rental properties. The first-occupied-five years before loan execution provision prohibits such financings. While the home may meet the first-occupied-five year test, the 1-3 rental units that would be created do not. This is also true of loans made to owner-occupants for purposes of adding 1-3 rental units within the 1-4 unit overall limitation.

The problem of elderly low income owners of large energy inefficient homes in older New Jersey cities is particularly critical.

The dollar limits for home improvement loans ($15,000 regardless of the number of units) should be expanded to include 1-4 unit properties within FHA Title 1 dollar amount limitations.

Specifically the New Jersey Mortgage Finance Agency wishes to go on record with the House Ways and Means Committee in support of the Senate amendment to H.R. 4717 which clarifies and makes more workable the law and regulations pertaining to housing programs using mortgage revenue bonds.

In doing so, we hasten to point out that the provisions of the Senate amendment do not resolve all of the issues and problems of the mortgatge revenue bond program, but they are a significant step in the right direction.

Congress and the committee hold the key to the fate of the mortgage revenue bond program and the assistance it can provide to deserving families. Over 30,000 New Jersey families are living in homes which have been financed by the New Jersey Mortgage Finance Agency and 5,000 New Jersey families are living in homes made safer, more habitable and energy-efficient through the New Jersey Mortgage Finance Agency's Home Improvement Loan Program loans.

Congress should quickly pass the Senate amendments to H.R. 4717 which provide some relief with arbitrage restrictions by changing the 1 percent limit to a sliding scale from 1⅛ percent up to 1⅛ percent, and also protect against loss on sale of reserves and fix the 20 percent low income requirement to 80 percent of median income for 10 years. Present law implies a 20 year term.

We also include a recommendation to extend the sunset provision of the Mortgage Subsidy Bond Tax Act of 1980 to 1985. The provision of the sunset provision is to allow Congress to review the effectiveness of this program. Given the delays in implementing the new regulations, an extension of the sunset date seems appropriate.

Tax benefit transfer leasing (safe harbor or leverage leasing)

New Jersey supports the attempt to limit the use of leverage leasing to certain public enterprises such as mass transit. Our support of the transit safe harbor leasing provsions of the Economic Recovery Tax Act of 1981 stems from our belief that the private sector must be given incentives to invest in mass transit if such investment is to occur at all, given the plethora of investment options available to private corportations. The current federal law offers such a long-sought opportunity to encourage private investment.

If the safe harbor leasing provisions are repealed for mass transit as well as other businesses, the question of how best to encourage private sector support of public transportation remains. Even without safe harbor leasing, profitable corporations with federal tax liabilities will seek tax shelters through such tax mechanisms as energy depreciation allowances, oil and gas exploration credits and real estate investments. In that context, retaining and even extending the tax incentivess for mass transit is sound public policy and is a separable issue from the merits of general safe harbor leasing.

As an example of how leverage leasing as applied to mass transit rolling stock can serve the public interest, the following hypothetical situation is sketched: New Jersey Transit Corporation sells the tax benefits associated with ownership of $50 million worth of rail cars for $2.4 million, or 24 percent of its 20 perecent local share. Over the term of that 30 year lease, the net loss to the United States Treasury is the investor's equity times the corporate tax rate ($2.4 million times .46) or $1.1 million. The transit corporation has realized $2.4 million, for a net gain of $1.3 million in buying power. If the Treasury "loss" were appropriated to the transit corporation, it would realize $1.1 million and the U.S. Treasury would spend $1.1 mil-

lion for a net gain of zero. The $1.3 million net gain realized through leasing would not enter the public accounts.

The New Jersey Transit Corporation has realized a gain through leverage leasing of approximately $1.9 million already. However, additional attempts to enter into safe harbor arrangements has been precluded because of the uncertainty surrounding the issues in Congress. New Jersey would like to see this issue resolved in favor of leverage leasing for mass transit so that the benefits of this tax mechanism may accrue to both the state and the federal government.

NEW JERSEY ECONOMIC DEVELOPMENT AUTHORITY, TRENTON—ANNOTATIONS ON ELIGIBLE LOCATIONS (TARGETING AUTHORITY ASSISTANCE) PURSUANT TO N.J.A.C. 19:30–4.1 ET. SEQ., JULY 1, 1981

These annotations explain the requirements of eligibility for financial assistance pursuant to N.J.A.C. 19:30–4.1 et. seq. according to location, with exceptions thereto. These annotations may be referred to as "Targeting Authority Assistance." They consist of two parts: Part I—Eligible Locations. Part II—Exception Provisions.

N.J.A.C. 19:30–4.1 et. seq. is the formal regulation for targeting Authority assistance. It applies to all projects for which financial assistance initially has been authorized by a resolution of the members of the Authority on or after July 1, 1979.

PART I—ELIGIBLE LOCATIONS

The Authority's program of financial assistance shall be rendered to businesses which are located in those municipalities as determined by either of the following two criteria: 1. New Jersey Urban Aid Municipality; or 2. NJEDA UIR Index Municipality.

The list of municipalities which meet at least one of the two criteria is given on pages 3, 4, and 5. All of these municipalities are eligible locations for a period of 12 months or more as determined by the Executive Director of the New Jersey Economic Development Authority.

1. New Jersey urban aid municipalities

Chapter 14 of the Public Laws of New Jersey (1978) provides for the state to grant funds to certain municipalities for the purpose of maintaining and upgrading public services and to offset high local property taxes. The designation of a municipality for participation in this program is made according to a formula given in the statute, as follows:

—Population exceeds 15,000 or exceeds 10,000 per square mile; and

—There exists publicly financed housing; and

—The number of ADC children exceeds 350 ("ADC children" means the number of children between the ages of 5 and 17 years in the municipality enrolled in the Aid to Dependent Children Program administered by the New Jersey Division of Public Welfare); and

—The municipality's equalized tax rate exceeds the state equalized tax rate; and

—The municipality's equalized valuation per capita is less than the state equalized valuation per capita; or

—The municipality is entered as a line item for such grants.

2. NJEDA UIR index

The Authority has identified those municipalities in New Jersey that have high unemployment, low per capita income, low municipal ratables per capita, all three measured against state averages, and a very high absolute number of unemployed persons living in the municipality. From these data a "UIR" index was developed. (The abbreviation "UIR" derives from: U = unemployment; I = income; R = ratables.) Any municipality meeting any three of the following four factors is eligible for the Authority's financial assistance:

(A) High unemployment rate.—This indicator consists of an average annual unemployment rate which is higher than the state average for 1980, 1979, and 1978.

(B) Low per capita income.—This indicator consists of per capita income which is lower than the state average for 1977, 1975, and 1974.

(C) Low ratables per capita.—This indicator consists of ratables per capita which are less than the state average for 1980, 1979, and 1978. A "ratable" is a taxable parcel of real property, and state equalized valuation was used as the dollar value of a municipality's ratables. This in turn was placed as numerator and the municipality's population was placed as denominator to calculate "ratables per capita".

(D) One thousand or more unemployed.—This indicator consists of any locality in New Jersey which has 1,000 or more persons unemployed in 1980, regardless of the population of that locality.

NEW JERSEY ECONOMIC DEVELOPMENT AUTHORITY—ELIGIBLE LOCATIONS FOR NJEDA FINANCIAL ASSISTANCE BASIS OF ELIGIBILITY, JULY 1, 1981 (TOTAL, 130)

	Urban aid	NJEDA UIR
Atlantic County:		
Atlantic City	×	×
Buena		×
Buena Vista		×
Corbin [1]		
Egg Harbor City		×
Galloway [1]		
Pleasantville [1]		×
Bergen County:		
Bergenfield [1]		
Fairview [1]		
Garfield		×
Hackensack [1]		
Lodi	×	×
Rockleigh [1]		
Burlington County:		
Beverly [1]		
Easthampton		×
Fieldsboro		×
Florence		×
Mount Holly		×
New Hanover		×
North Hanover		×
Pemberton Boro		×
Pemberton Township		×
Riverside [1]		
Southampton		×
Willingboro	×	
Camden County:		
Camden	×	×
Gloucester City		×
Gloucester Township	×	
Lawnside		×
Lindenwold	×	
Magnolia		×
Mount Ephraim [1]		
Pennsauken	×	×
Waterford		×
Wood-Lynn		×
Cape May County:		
Cape May City [1]		
West Cape May [1]		
West Wildwood [1]		
Wildwood City [1]		
Woodbine		×
Cumberland County:		
Bridgeton	×	×
Commercial Township		×
Downe		×
Fairfield		×
Lawrence		×
Maurice River		×
Millville	×	×
Upper Deerfield		×
Vineland	×	×
Essex County:		
Belleville	×	×

NEW JERSEY ECONOMIC DEVELOPMENT AUTHORITY—ELIGIBLE LOCATIONS FOR NJEDA FINANCIAL ASSISTANCE BASIS OF ELIGIBILITY, JULY 1, 1981 (TOTAL, 130)—Continued

	Urban aid	NJEDA UIR
Bloomfield	×	
East Orange	×	×
Irvington	×	×
Montclair	×	
Newark	×	×
Orange	×	×
West Orange	×	
Gloucester County:		
Clayton [1]		
Elk Township [1]		×
Glassboro	×	
Monroe		×
Newfield		×
Paulsboro		×
Swedesboro		×
Westville		×
Hudson County:		
Bayonne	×	×
East Newark		×
Guttenberg		×
Harrison		×
Hoboken	×	×
Jersey City	×	×
Kearny Township	×	
North Bergen	×	×
Union City	×	×
Weehawken Township	×	×
West New York	×	×
Hunterdon County:		
Lambertville [1]		
Mercer County:		
Hamilton		×
Trenton	×	×
Middlesex County:		
Carteret	×	
Dunellen		×
New Brunswick	×	×
Old Bridge	×	×
Perth Amboy	×	×
South Amboy		×
South River		×
Spotswood		×
Monmouth County:		
Asbury Park	×	×
Belmar [1]		
Bradley Beach		×
Farmingdale		×
Highlands		×
Howell		×
Keansburg	×	×
Keyport [1]		
Long Branch	×	×
Neptune Township	×	×
Red Bank [1]		
Roosevelt [1]		
South Belmar [1]		
Union Beach		×
Morris County:		
Butler		×
Mine Hill		×

NEW JERSEY ECONOMIC DEVELOPMENT AUTHORITY—ELIGIBLE LOCATIONS FOR NJEDA FINANCIAL ASSISTANCE BASIS OF ELIGIBILITY, JULY 1, 1981 (TOTAL, 130)—Continued

	Urban aid	NJEDA UIR
Ocean County:		
Jackson		×
Lakehurst		×
Lakewood	×	×
Point Pleasant Boro		×
Passaic County:		
Clifton [1]		
Haledon		×
Passaic	×	×
Paterson	×	×
Prospect Park [1]		
Salem County:		
Penns Grove [1]		
Quinton		×
Salem		×
Upper Pittsgrove		×
Woodstown [1]		
Somerset County:		
None		
Sussex County:		
Franklin		×
Newton		×
Walpack		×
Union County:		
Elizabeth	×	×
Hillside Township	×	
Linden [1]		
Plainfield	×	×
Rahway	×	
Roselle	×	
Winfield		×
Warren County:		
Alpha [1]		
Hackettstown		×
Phillipsburg	×	

[1] Carryover eligibility from July 1, 1980 list; if municipality does not meet the criteria for 1982, it will lose eligibility as of July 1, 1982.

PART II—EXCEPTION PROVISIONS

A—Waivers

The purpose of targeting financial assistance is to provide economic stimulation to localities suffering economic hardship where such financial assistance will save jobs that would otherwise be lost or which will provide for new, permanent jobs in that locality, or which will strengthen the tax base of a municipality. With this overriding purpose in mind it is realized that the list of municipalities derived from crietria 1 and 2 in Part I may exclude a deserving and significant project within the general spirit and purpose of the targeting plan. Accordingly, NJEDA will accept applications for such projects for review on a case-by-case basis and may approve such projects in a non-listed municipality if they involve any of these conditions and considerations:

1. Assistance will be considered in connection with a substantial natural or economic disaster, or threat of same. This condition will apply to actual or threatened loss of many jobs, impending or actual shutdown of a military installation, business, or public facility employing many persons, or natural disasters.

2. Assistance will be considered for a project located in a designated urban renewal area, even if located in a non-listed municipality. The urban renewal area must be duly and officially designated and be the subject of an organized community redevelopment effort.

3. Assistance will be considered for projects which will employ significant numbers of disadvantaged persons, as determined by a contract with a CETA prime sponsor or equivalent local manpower program.

Applications for such projects shall be handled according to usual procedure, which includes staff evaluation and recommendation and final disposition by the Members of the Authority.

B—Exempt projects

Projects of the type described below are exempt from the locational restrictions given in Part I, and may receive financial assistance no matter where located, provided other Authority requirements are met:

1. Certain industrial and office projects provided that the project is not a speculative facility, including

(a) Manufacturing.—This sector includes establishments engaged in the mechanical or chemical transformation of materials or substances into new products. These establishments are usually described as plants, factories, or mills and characteristically use power-driven machines and materials handling equipment. Assembling component parts of manufactured products as well as blending materials (oil, plastics, resins, liquor) are also considered manufacturing.

SIC Notations: 20–39 (Division D)

(b) Wholesale trade.—This sector includes establishments or places of business primarily engaged in selling merchandies to retailers; to industrial, commercial, institutional, farm, or professional business users; or to other wholesalers; or acting as agents or brokers in buying merchandise for or selling merchandise to such persons or companies.

SIC Notations: 50, 51 (Division F)

(c) Transportation—motor freight transportation and warehousing.—A subset of the general transportation and public utilities sector, this major group includes establishments furnishing local or long-distance trucking, or transfer services, or those engaged in the storage of farm products, furniture, and other household goods, or commercial goods of any nature. The operation of terminal facilities for handling freight, with or without maintenance facilities is also included.

SIC Notations: 42 (Division E)

(d) Large office buildings.—The distinction between a small and a large office building is based on the Authority's experience in real estate financing. For the purpose of targeting, "large office building" shall mean a facility with at least 20,000 net rentable square feet.

An office building in which at least 20,000 net rentable square feet shall be used for central administrative offices is exempt from Part I (locational) requirements if so committed prior to official action by the Authority. An example would be a company headquarters or regional office serving business operations outside of as well as within New Jersey.

A "central administrative office" is an establishment primarily engaged in general administrative, supervisory, accounting, purchasing, engineering and systems planning, advertising, legal, financial, or related management functions performed centrally for other establishments of the same company. "Central administrative offices" characteristically do not produce any products nor do they provide any services except as a consequence of headquarters operations. The definition of a "central administrative office" given in the Standard Industrial Classification Manual, shall be the basis for judgment by the Authority on this matter.

Eligibility criteria for financing of large office buildings are: (1) The office facility must consist of at least 20,000 net rentable square feet; (2) The facility must be nonspeculative in nature, that is, 40 percent of the total facility to be constructed must be under lease commitments; (3) A minimum of 20,000 net rentable square feet must be leased by a single user as a "central administrative office."

Definition of Speculative Facility.—The Authority defines a speculative facility as a project which will be acquired, constructed or equipped and does not have written commitments, satisfactory to the Authority, for the purchase or rental of a minimum of 40 percent of the net usable space prior to official action by the Authority.

2. Certain industrial and public benefit projects, including

(a) Commercial fishing.—These types of projects include the commercial catching or taking of finfish and shellfish, fish farms, and fish hatcheries.

SIC Notations: 09 (Division A)

Fish packing is included in Section 1(b) above (Wholesale Trade) and subsequent fish processing is included in Section 1(a) above (Manufacturing).

(b) Motion picture production and allied services.—A subset of the Service Industry (Division I), the motion picture production and allied services activity includes production of theatrical and non-theatrical motion pictures for exhibition, for television, including commercials as well as motion picture film processing, editing and titling, casting bureaus, wardrobe and studio property rental, television tape services (editing, transfers, etc.) and stock footage of film libraries.

SIC Notations: 781 (Division I)

(c) Research and development laboratories.—These are establishments primarily engaged in physical research and development on a contract or fee basis. Research and development laboratories of companies engaged in manufacture are classed as manufacturing auxiliaries (Section 1(a) above).

SIC Notations: 7391 (Division I)

(d) Certain public facilities.—Section 103(b) (4) and (5) of the Internal Revenue Code exempts the financing of certain types of facilities from the capital expenditure limitations of industrial revenue bond financing because of their economic development importance. That same reasoning carries over herein. The types of facilities include but are not limited to:

1. Airports, docks, wharves, mass commuting facilities, parking facilities, or storage or training facilities directly related to any of the foregoing, available to the general public.
2. Convention or trade show facilities.
3. Industrial pollution control facilities.

(e) Proprietary nursing homes and other licensed health care facilities.—New Jersey faces a shortage of standard nursing home facilities for the elderly. This shortage causes hardship for many persons who either must purchase care in a substandard facility or forego needed care altogether. Because the construction and renovation of such facilities are so directly linked to the health and welfare of New Jersey residents statewide, the Authority may provide assistance to such projects wherever located.

3. Certain agricultural projects, including

(a) Agricultural production—crops.—These types of projects include establishments primarily engaged in the production of crops or plants, vines and trees.

SIC Notations: 01 (Division A)

(b) Agricultural production—livestock.—These types of projects include establishments primarily engaged in keeping, grazing, or feeding of livestock for sale of livestock or livestock products, or for livestock or value increase.

SIC Notations: 02 (Division A)

(c) Agricultural services.—The services provided by these types of businesses include soil preparation, crop services, veterinary services, other animal services, and farm and labor management services. Non-farm retail sales and services are not included in this exemption.

SIC Notations: 07 (Division A)

(d) Forestry.—These types of projects include establishments primarily engaged in the operation of timber tracts, tree farms, forest nurseries, and related activities such as reforestation services and the gathering of gums, barks, etc. and other forest products.

SIC Notations: 08 (Division A)

ADDENDUM TO ANNOTATIONS ON ELIGIBLE LOCATIONS (TARGETING AUTHORITY ASSISTANCE) PURSUANT TO N.J.A.C. 19: 30–4.1 ET. SEQ. JULY 1, 1981

Revised municipal unemployment data has been made available to the Authority. Examination of this information reveals that three additional municipalities qualify as eligible locations for Authority financing assistance according to the NJEDA UIR Index. These municipalities are: Burlington City (Burlington County); Englishtown Boro (Monmouth County); Hopewell Township (Cumberland County).

In addition, a revised list of the state's "urban aid" cities shows that four municipalities now qualify as eligible locations for Authority financing on this basis. These new "urban aid" cities are: Hamilton Township (Mercer County); Harrison Town (Hudson County); Jackson Township (Ocean County); Winslow Township (Camden County).

Among these new "urban aid cities", Hamilton Township, Harrison Town and Jackson Township were already qualified as eligible locations for Authority project financing assistance according to the NJEDA UIR Index.

These additions to the list of municipalities eligible for Authority financing assistance are effective immediately.

STATEMENT OF THE NEW YORK STATE ECONOMIC DEVELOPMENT COUNCIL, INC.

ANALYSIS OF AND RESPONSE TO THE U.S. TREASURY DEPARTMENT'S PROPOSALS TO LIMIT THE USE OF ALL INDUSTRIAL DEVELOPMENT BONDS

General comments

The New York State Economic Development Council, Inc. is the statewide association of professional industrial and economic developers in the Empire State, and represents more than 250 members from throughout the State.

As an organization committed to continued and increasing economic growth and development in New York, the Council is deeply concerned over recent proposals regarding possible Congressional limitations on the use and application of Industrial Development Bonds—a development tool that the membership considers critical to continued growth and development.

Over the course of the past few years certain news media have focused a great deal of attention on the IDB program. Unfortunately, the great majority of that attention has been negative in nature, and the most vocal critics have overlooked, did not understand, or chose not to consider, the positive aspects of the program. There is unassailable proof that IDBs have been a major factor in the successful economic turnaround and recent job growth in New York State.

It is therefore essential that the use and application of IDBs be put into proper perspective if we hope to achieve a rational overview of the current situation. There is little doubt that the U.S. Treasury Department has, in the past, been a vocal critic of the IDB program—as evidenced by a series of eight negative proposals aimed at limiting the use of IDBs contained in a section of a February 26, 1982 report. That section, entitled, "Tax Exempt Bonds for Private Facilities", contains eight specific proposals that will be addressed herein.

That the Treasury is a most vocal critic of the IDB program is unjustifiable but understandable—as the potential "loss" of revenue to the Federal Treasury is the principal and historical preoccupation of Treasury personnel. It is the firm belief of the NYS-EDC that there is no "loss" but an actual "gain" of revenue to the Treasury. Far too little emphasis and attention has been focused on the economic benefits of the Industrial Development Bond program and the revenue gain by the Treasury as a result of their application. Any real or perceived short term loss of revenue to the Treasury is indeed insignificant and temporary when compared to those substantial long term benefits.

Since 1969, when legislation was approved in New York State which authorized the creation of Industrial Development Agencies, a total of $1.3 Billion in bonds have been issued to finance 658 projects. While the Economic Development Council is currently finalizing an in-depth economic impact study of bonds issued by Industrial Development Agencies throughout the state, the results of a similar study conducted in a two-county region (Nassau and Suffolk Counties) bear strong witness to the fact that the federal tax revenues generated as a result of IDA funded projects more than offset any revenue loss as a result of the tax-exempt status of the bonds. It should also be noted that such projects produce new state and local taxes which must be generated if the new Federalism program is going to work.

According to that two-county report, during 1980–81, some $195 million in Industrial Development Bonds were issued to finance projects in the Nassau-Suffolk region. As a direct result of such financing, 14,055 jobs were either created or retained, and direct payrolls of more than $198 million were generated. Based on the assumption that such payrolls are generated for a 10-year period, and that employees are taxed at a 20 percent federal marginal tax rate, more than $396 million in federal tax revenue would be generated as a result of those projects over the 10-year period.

Assuming that the Treasury's contention that approximately five percent interest is "lost" annually in Industrial Development Bonds is factual, the 10-year "loss" to the Treasury in the two-county area would be $48.993 million. Over that 10-year period, the Treasury would receive a $347 million "net gain" in revenue as a result of IDA financing over and above any "loss" attributed to the tax-exempt status. And that figure represents only a two-county area of a single state, and no mention was made of the other tax revenues generated on both the state and local levels.

In addition to the contention that Industrial Development Bonds result in a drain on the Treasury, opponents and critics of the program have maintained that Industrial Development Bonds serve as a "giveaway" program to large corporations that are not in need of such tax-exempt financing.

The Economic Development Council would call attention to the statistics contained in the April 1, 1981 study of Industrial Development Bonds conducted by the

Congressional Budget Office. That report states, "Of some 8,000 small issues in 1978 and 1979, only seven percent went to the top 'Fortune 50' non-industrial companies or the top Fortune industrial 1,000 firms . . . CBO found that, in terms of the dollar volume of sales in 1978 and 1979, only 16 percent was for Fortune 1,000 of Fortune 50 companies."

The remaining 84 percent of Industrial Development Bonds issued in that period were used to finance small and medium size business projects. And, in New York State, it is the small and medium size business sector which creates nearly 80 percent of all new jobs and turns out the majority of the new business developments needed to maintain the competitive position of both this state and this nation in the economy of the world. To enact any measure which would severely limit or totally eliminate the Industrial Development program—as any one of the first seven of the eight Treasury Department proposals is more than capable of doing—would successfully close off an essential means of financing the capital needs of our small and medium size business sector.

Elimination of Industrial Development Bonds would subsequently force those small and medium size businesses to attempt to secure necessary capital at interest rates which exceed prime by as much as two percent (now approximately 18 percent). These businesses can now receive financing at 75 percent of prime (now approximately 12 percent) by using IDB's. Such elimination very easily raises the cost of new facilities and needed improvements to prohibitive levels. The Massachusetts Industrial Finance Agency in its October 1981 report on IDB's in the Bay State concluded ⅓ of the IDB users would have cancelled their expansion without IBD's and nearly another ⅓ would have delayed their expansion.

If a facility is not constructed, or necessary improvements are not made, then not only are new jobs not created, but existing jobs are lost. The proposed elimination of IDB's serves two purposes: (1) it stops the generation of new revenue to the Federal Treasury, and (2) it places a new drain on federal dollars in the form of increased unemployment and social welfare benefit costs.

The Treasury points to what is termed the "alarming" increase in the use of Industrial Development Bonds over the course of the past five years and to usage projections in the forthcoming years. The NYS Economic Development Council asks that consideration also be given to tracing the path of interest rates over that same five year period. It is the experience of developers in New York State that the majority of businessmen, given the selection between conventional and Industrial Development Bond financing, would rather finance capital projects through conventional sources.

However, with the prime rate now in the area of 16 percent, and having reached as high as 20 percent in the recent past, conventional financing is simply an unrealistic option for small and medium size businesses. If we were to reduce federal borrowing (which now encompasses 28 percent of the credit market, as compared to six percent in the 1950's and 1960's), and reduce federal spending, we could bring interest rates back to a realistic and manageable level, and we would find more and more small and medium size businesses going back to the conventional market.

Given the current market conditions, Industrial Development Bond financing cannot be viewed solely as an option of financing which provides an interest rate incentive—it must be viewed as the only alternative of financing necessary capital projects for small and medium size businesses. If we remove that single alternative, we will have effectively closed the door on contined business investment, and economic growth and recovery.

THE U.S. TREASURY DEPARTMENT PROPOSALS

The 8 specific U.S. Treasury Department proposals and the responses to each by the New York State Economic Development Council, Inc., are as follows:

Treasury proposal No. 1: "The highest elected official or legislative body, for example, the mayor or city council, of the governmental unit issuing the bonds and in which the facility is located must approve the bonds after a public hearing. Alternatively, the public approval requirement could be met by a voter referendum on the bonds to be issued for the particular facility."

NYS-EDC response: As stated below under Conclusion, a "public purpose" is required for each project in New York.

Under New York State law, each industrial development agency is classified as a public benefit corporation (Article 18-A, General Municipal Law) and, as such, each is bound by Section 99 of the State's Public Officers Law which requires, "Every meeting of a public body shall be open to the general public . . . " As a result, all business conducted by an industrial development agency is done in an open fashion

and in the full view of the general public. Also under New York Law, a majority of the total authorized membership of an agency must approve each bond issue.

Public hearings, on the other hand, are designed for the purpose of soliciting public input—usually with regard to proposed legislation or regulations. In the "Technical Explanation" portion of its report entitled, "Tax Exempt Bonds for Private Activities," the Treasury Department States, "To ensure that tax exempt obligations issued for private activities serve valid public purposes, the obligations must be approved, after a public hearing, by the highest elected official or legislative body of the jurisdiction in which the project is located, or by a voter referendum." As stated previously in this paper, the public purpose of industrial development agencies in New York State is explicitly detailed in the 1969 enabling legislation (Section 18-A, General Municipal Law).

Under the requirements of the New York State Constitution, each agency is created by an Act of the State Legislature. The State and the local taxpayers are insulated from liability on the special obligation revenue bonds now issued. In the opinion of the New York State Economic Development Council, any action which would require the approval of the bond issuance by the highest elected official or legislative body in the jurisdiction in question poses the very real threat of endangering the assets of the state and the municipality and could open both the elected official or the municipality to liabilities which, under the current statute, are protected against. In addition, this requirement, if enacted, could easily politicize what is now a non-political function. Why mandate additional and costly bureaucracy?

Treasury proposal No. 2: "In the case of bonds issued after December 31, 1985, the governmental unit must make a contribution of commitment to the facility financed with tax-exempt bonds. The contribution could take the form of a cash payment, tax credit or abatement, provision of additional services, or payment of the bond issuance expenses with a value on the date the bonds are issued equal to one percent of the face amount of the bonds. Alternatively, the issuing govermental unit can satisfy the commitment requirement by insuring or guaranteeing the bonds or designating the bonds as general obligations of the State or local government."

NYS-EDC response: Taking into consideration the many complementing programs that are used in tandem with the issuance of industrial development bonds, the State of New York and the issuing municipality, in actuality, make a contribution and commitment to the facility that is much greater than the one percent of the face value of the bonds, as outlined in this proposal.

There is no personal property tax in New York State.

Section 485-b of the State's Real Property Tax Law provides real property tax abatements of up to 50 percent of the assessed valuation of the new facility, with the abatement declining by five percent annually over a 10-year period. Section 874 of Article 18-A of the General Municipal Law stipulates that an agency, ". . . shall be required to pay no taxes or assessments upon any of the property aquired by it under its jurisdiction . . ." As a result, a project that receives industrial development bond financing in New York State pays no sales tax on construction materials or on production equipment utilized within the facility.

Mortgages issued to secure IDB transactions are also exempt from filing fees and mortgage taxes in New York State.

Clearly, the contributions provided to a project by both the State and the issuing municipality as a means of stimulating new business investment far exceed the one percent contribution which would be required under the provision. Let us preserve whatever home rule powers we now have, and let each State determine its own local tax incentives.

It is the firm belief of the Economic Development Council that the proposal to require either the state or the locality to guarantee industrial development bonds or to designate the bonds as general obligations is a thinly veiled ploy to put a stop to the use of industrial development bonds not only in New York State, but in some 30 other states in which the Constitution specifically prohibits state and local governments from lending money or credit to non-governmental entities.

At the present time, New York State is working diligently to continue established programs identified as essential with reduced revenue from the federal government. While the New York State Economic Development Council Inc. firmly grasps and supports the concept of the "New Federalism", the council questions the implementation of a proposal which would add the potential of an additional state or local expense to a program which has proven to be extremely effective in promoting economic development.

Treasury proposal No. 3: "The costs of depreciable assets financed with tax-exempt bonds must be recovered using straight-line depreciation over the extended recovery period used for earnings and profits computation purposes."

NYS-EDC response: The New York State Economic Development Council believes this proposal is not only another veiled attempt to put a halt to the use of industrial development bonds in New York State and throughout the nation, but is also a measure which would place an undue burden—and indeed a penalty or punishment on those companies which are the true job generators in New York State and are most in need of tax-exempt financing—the small and medium size businesses. Accelerated Cost Recovery, since its adoption as a component of the Economic Recovery Act of 1981, is the method by which all businesses across the nation may depreciate their assets. It is the small and medium size businesses which are not in the position to internally capitalize their construction and expansion projects and cannot afford conventional financing at current interest levels. Thus, it is the small and medium size businesses that are truly in need of, and truly utilize tax-exempt industrial development bond financing. Don't squeeze small and medium sized businesses with this proposal.

Can we in New York State, or anywhere in our nation, afford to penalize those businesses that are growing and creating jobs by forcing them to depreciate their assets over a 35-year period, when those firms which can afford internal capitalization or conventional financing can recover costs utilizing the 10–5–3 program? The New York State Economic Development Council strongly believes we cannot.

It would appear to the more than 250 members of the Council that, given the current economic climate, new and growing businesses should be encouraged and given the incentive to grow, expand and create jobs, rather than be punished and penalized for doing so.

Treasury proposal No. 4: "Exempt small issue IDB's will be limited to small businesses. A small business is defined as a business that has capital expenditures of less than $20 million over a six-year period. In addition, bonds would not qualify as exempt small issue IDB's if the business will have more than $10 million of IDB's outstanding after issuance of the bonds."

NYS-EDC response: While this proposal may seem acceptable at first, the New York State Economic Development Council believes it is thoroughly flawed, and will ultimately serve as a strong disincentive to continued investment and expansion of those firms which have utilized IDB financing in New York State. This proposal not only excludes the thousands of medium sized companies that need IDB's to survive and expand but also excludes hundreds of businesses qualified by the U.S. Small Businesses Administration.

Again, the Council would emphasize that policies which provide an incentive for continued growth and expansion should and must be implemented, rather than policies that provide for a disincentive. The placing of a $20 million capital expenditure limitation over a six-year period (three years back and three years forward) and the imposition of a $10 million outstanding bond disqualification would have an adverse impact on future investment incentives. The six-year capital expenditure limitation would also serve to delay capital investments at a time in which continued capital investment is critical to continued economic growth and revitalization. Why should a company be discouraged from continuing to expand? There is no valid reason for the present or proposed capital expenditure rule.

The $20 million ceiling would have a distinct negative impact on New York State, which has logically determined that the key to its economic future lies in nurturing the growth of high technology industries. Such technology-oriented businesses operated in a highly competitive, innovation conscious and capital intensive atmosphere. The inclusion of research and development expenditures (which are normally operating costs, and are not generally capitalized) in the present and proposed $20 million capital expenditure limitation would serve as an investment disincentive for exactly the type of growth potential firms this state is attempting to attract and nurture.

Moreover, it is the opinion of the Economic Development Council that the overall capital expenditure limitation stipulation has never been fully justified—except as a means of providing a disincentive to utilize the Industrial Development Bond program. While not justified, and not considered satisfactory by NYS-EDC, the present capital expenditure rule does work under the "incorporated municipality" concept.

Treasury proposal No. 5: "With these restrictions, small issue IDB's could be sold as a part of a composite or umbrella issue of bonds."

NYS-EDC response: The reinstatement of the use of composite issues is a measure which is direly needed if we are to attempt to stimulate the growth of small and medium size businesses, and in the opinion of the Council, should never have been restricted (Revenue Ruling 81-216). Industrial Parks, condominium buildings, and other multi-tenant and multi-ownership projects need the availability of common guarantees and common letters of credit. Composite letters of credit are a new inno-

vative industrial tool and should not be discouraged. Composite issues of bonds makes it possible for the costs involved in their issuance to be spread out over several issues, and has allowed the small business segment to participate in the program. When the ability to issue composite issues was taken away, the types of businesses most in need of IDB financing were virtually excluded from taking part in the program. At least 32 states would be seriously affected by this proposal.

Treasury proposal No. 6: "Each bond must be in registered form and information concerning the issuance of the obligations must be reported by the state or local government to the Internal Revenue Service."

NYS–EDC response: There would be no useful purpose served by requiring all bonds to be registered in the opinion of the New York State Economic Development Council. On the contrary, such a requirement would effectively add a bureaucratic barrier to a program which is now relatively free of such red tape. It is important here to point out the fact that registration of bonds is totally unnecessary in New York State, which has had only *two* defaults in more than $1 billion of industrial development bond financing.

In addition to adding yet another level of bureaucracy to the program, requiring registration of the bonds would increase the interest rate by as much as one-quarter to one-half of a percent on each issue. Registration limits flexibility and reduces liquidity. In a time when the emphasis is on the streamlining and easing of governmental regulations, adoption of this measure would again "fly in the face" of new policies and philosophies. Registration is big brother philosophy and places an undue and costly burden on the local agency.

Currently in New York State, the State Department of Commerce each year collects pertinent data from all industrial development agencies operating in the state for the compilation of a statistical report. This reporting process is effective, relatively simple and, above all, extremely cost effective.

Treasury proposal No. 7: "Restrictions on the investment yield from the use of the proceeds of the obligations are extended to reserve funds and funds held during the temporary construction period. Bond costs may not be taken into account in determining the yield for purposes of the arbitrage limitations."

NYS–EDC response: This proposal would make a great deal of sense were someone attempting to put a halt to the Industrial Development Bond program. Otherwise, it is totally unjustified and would completely counter the "stop the big boys and help the little guys argument" of the Treasury Department.

Small and medium size firms which currently utilize industrial development bond financing are enabled to generate a portion of the proceeds of a bond issue. Should this measure be enacted, the inability to earn interest on invested funds would have two possible results—it would force the borrower to seek more financing up front, or it would make such projects infeasible. At this point in time, construction work delays and increasing costs of materials are virtually inevitable. If the borrower is unable to invest a portion of the bond proceeds during the construction period, the alternative would to borrow a larger amount up front. It would appear illogical for the Treasury Department, which contends that Industrial Revenue Bonds are a drain on the Treasury (a contention strongly disputed by the Economic Development Council) to propose adoption of a measure that would serve to increase borrowing.

In New York State, Industrial Development Bond issues do not customarily provide for "reserve funds" and when used are normally limited to one year's maximum debt service, but of necessity almost all projects do use "construction funds". Compliance of most "reserve funds" with arbitrage regulations can be calculated relatively accurately into the future, but an accurate projection of "income" or a temporary construction fund is next to impossible. The purchase of special U.S. Treasury obligations is an inflexible alternative which would hamper rather than help small and medium-sized businesses.

Treasury proposal No. 8: This proposal relates to Housing Bonds and the New York State Economic Development Council, Inc. is not involved in housing projects and, therefore, has no comment on the housing proposal.

CONCLUSION

Given the concept and the philosophy of the "New Federalism", it is evident to the New York State Economic Development Council that the proposals unveiled by the Treasury Department fly directly in the face of that prevailing philosophy. There is no question that, when all is considered, the locality remains in the best position to determine what "public purpose" is served by small issue Industrial Development Bonds. Industrial Development Bonds have been an extremely effective

development tool in New York State because they are relatively free of the costs and complex procedural operations that earmark other economic development programs. Section 18-A of New York State's General Municipal Law, which the enabling legislation for Industrial Development Agencies, specifically states, ". . . the use of all such rights and powers is a public purpose essential to the public interest . . .", That "public purpose" is defined in the legislation as promoting, "the economic welfare, recreation opportunities and prosperity of its inhabitants to actively promote, attract, encourage and develop recreation and economically sound commerce and industry through governmental action for the purpose of preventing unemployment and economic deterioration by the creation of industrial development agencies which are hereby declared to be governmental agencies and instrumentalities . . ."

Who can better determine and define sound commerce and industry in a locality than the representatives of the locality itself? Most IDB's in New York State are issued by local Industrial Development Agencies which are individually created by a special Act of the State Legislature and whose members are appointed and at will removed by the local legislative body.

At a time of recession, threatened depression, and fantastically high interest rates, this is not the time to destroy workable programs that allow our nations businesses to finance job producing projects. Research and development should be excluded from the henious capital expenditure rule, or the rule should be abolished. The present dollar limitation of $10 million dollars should be increased to reflect the inflation of construction costs in the last 5 years.

If the new federalism is to succeed, successful programs such as Industrial Development Bonding, should be encouraged and enhanced; not limited and destroyed.

The New York State Economic Development Council, Inc. asks everyone to help preserve the successful IDB program.

Statement of Views of Peat, Marwick, Mitchell & Co. on Treasury Department's Completed Contract Method Proposals

LONG-TERM CONTRACT PROPOSALS

In a letter to you dated March 10, 1982, we indicated that we oppose and would be submitting detailed comments on the recent Department of Treasury proposals involving long-term contracts. The purpose of this letter and the attached detailed comments is to express the views of our Firm on the Treasury proposals to eliminate or severely restrict, either through legislation or regulations, the use of the completed contract method of accounting.

For the reasons more fully explained in the attached detailed comments, we believe that both sets of proposals should be withdrawn. Instead, we recommend that Treasury commence a dialog with both industry representatives and tax practitioners to address and resolve the perceived abuses under the current long-term contract regulations.

Summary of our firm's position

(1) The completed contract method has been part of the Income Tax Regulations since 1918 and has withstood the test of time as clearly reflecting income for Federal income tax purposes. If some taxpayers have not applied the method properly, that should be corrected throughout appropriate means other than legislation. However, we believe that the vast majority of contractors have properly used the method and should not be deprived of its continued use.

(2) The Treasury proposal in the Current Law section inaccurately states that the percentage of completion method yields a better measure of income than does the completed contract method. In fact, under current tax law, both methods are deemed equal terms of clearly reflecting taxable income.

(3) The Treasury proposal improperly describes and refers to generally accepted accounting principles (GAAP) in reaching the conclusion that the completed contract method does not clearly reflect income for Fedral income tax purposes. The stated reasons for change are premised on the concept of conformity between Federal income tax accounting and financial statement accounting. This concept clearly was rejected by the Supreme Court in *Thor Power Tool Company* v. *Commissioner,* 439 U.S. 522 (1979).

(4) For no apparent reason, a contractor no longer would be permitted to use previously acceptable methods of accounting for tax purposes such as the cash receipts and disbursements method or the accrual method.

(5) The new "progress payments method" that would be encouraged by Treasury should be abandoned because it departs from fundamental tax equities and cannot

be reconciled with the tax accounting rules applied to accrual method manufacturers, merchandisers, or providers of services.

(6) The proposed contract costing rules are inconsistent with case law existing prior to 1976 and acknowledged by Treasury as forming the basis of the present costing rules contained in section 1.451-3 of the Income Tax Regulations. See 41 Fed. Reg. 2636 (1976). Moreover, the new rules, in many cases, would result in arbitrary cost allocations and would also eliminate some of the intended tax benefits resulting from the Economic Recovery Tax Act of 1981.

(7) It appears that contractors who account for revenue on the accrual acceptance or shipment method will be denied the right to use standard inventory methods and, instead, will have to use the proposed contract costing rules for their inventories. Thus, such contractors apparently will not qualify for the use of the first-in, first-out (FIFO) or the last-in, first-out (LIFO) method.

(8) Many manufacturers and processors who account for revenue on the accrual acceptance or shipment method will have to use the same proposed contact costing rules as contractors described in (7). This proposal is illogical since many such manufacturers and processors presently are not eligible to use a long-term contract method.

We appreciate your consideration of our views and would be pleased to discuss them with you or members of your staff at your convenience.

PEAT, MARWICK, MITCHELL & CO.,
Washington, D.C., March 10, 1982.

Hon. DONALD T. REGAN,
Secretary of the Treasury,
Washington, D.C.

DEAR MR. SECRETARY: Peat, Marwick, Mitchell & Co. serves as accountants, auditors, financial and tax advisors to the Construction Industry. Our clients in this industry include both prime and sub-contractors, large and small, in the 50 states.

As Chairman of the Firm's Construction Contractor Committee, we oppose any effort to eliminate or significantly modify the completed contract method of accounting for Federal income tax purposes. If there are any significant areas of abuse in the use of the method, we suggest that a committee with members from the Treasury, Internal Revenue Service, Contractors and Tax Practitioners meet to resolve them. The completed contract method has been in effect for over 64 years as a tax principle and has withstood the test of time and criticism as a method that clearly reflects income for tax purposes. In addition, the elimination of this method would pose an undue hardship on the industry.

We submit to you a detailed analysis in support of our views which you may consider along with the many comments that I am sure you are receiving from the Contractor Industry.

Very truly yours,

FRANCIS E. KASTENHOLZ, *Partner.*

Attachment.

DETAILED COMMENTS BY PEAT, MARWICK, MITCHELL & CO. ON LONG-TERM CONTRACT PROPOSALS

General comments

The Treasury Department's release on February 26, 1982, contains a number of legislative and regulatory proposals to revise the federal income tax accounting rules for long-term contracts. This memorandum addresses eight major areas that form the basis for our recommendation that the proposals be withdrawn.

The Treasury release contains Treasury's explanation of the current law and the reasons why changes are necessary. The explanation of both the current situation and reasons for change includes contradictory references to generally accepted accounting principles (GAAP) and their relationship to tax accounting for Federal income tax purposes. The proposal refers to GAAP to attempt to justify the repeal of the completed contract method but depart from GAAP in developing the new "progress payment" method of accounting for long-term contracts.

Perhaps the most disturbing aspect of the legislative proposal is the fact that it would apply to long-term contractors a special set of tax accounting rules that are totally different from the tax accounting rules applied to all other segments of our economy. The proposal, when viewed in its totality, results in a system of taxation being applied to contractors that cannot be reconciled with the system being applied to accrual method manufacturers, merchandisers, and providers of service.

With regard to the regulatory proposals, they represent a significant over-reaction to perceived problems with the completed contract method of accounting and attempt to deny without justification the use of other accounting methods that are currently allowed. In our view, the regulatory proposals should be completely revised before they are published as proposed regulations.

Clear reflection of income

The completed contract method has been an accepted method of accounting for Federal income tax purposes for over 60 years and has withstood the test of time as clearly reflecting taxable income. Without question, the completed contract method is one of the most easily understood and widely used methods of accounting under the Income Tax Regulations. The method operates to tax a contractor's income of the point in time when the income or loss on the contract is known—the time of completion and acceptance.

The completed contract method was used primarily by construction contractors prior to 1976. However, during the late 1960s and early 1970s, it was recognized that the long-term contract rules were in need of revision and, despite the previous widespread use of the completed contract method, the Treasury Department in 1976 culminated a five-year regulations project by issuing new long-term contract regulations. These regulations both redefined the term "long-term contract" and also brought more taxpayers within the scope of being eligible to use a long-term contract method. The revisions were made so that previously existing case law could be elevated to the status of regulations thereby providing a higher degree of certainty for both the Treasury Department and taxpayers in dealing with long-term contract issues.

The promulgation of the final regulations in 1976 was a long and difficult process that involved the issuance of three different drafts of proposed regulations. Each of these drafts sought to impose restrictions or limitations on the use of the completed contract method. In the first draft, issued on March 24, 1971, the use of the completed contract method was coupled with a requirement that it also be used for financial reporting purposes. The financial statement conformity issue was viewed as a means of assuring that the completed contract method clearly reflected income for tax purposes. The second draft, issued, on December 15, 1971, provide that the completed contract method would be considered to clearly reflect income only if estimates of the cost to complete the contract and the extent of completion are not dependable. Thus, the second draft implied that the percentage of completion method was the preferred method but, if the estimates are not dependable, the completed contract method could be used.

The third draft of proposed regulations, issued on November 12, 1972, imposed a "clear reflection of income" standard for tax purposes on both the percentage of completion method and the completed contract method. However, this draft was deficient in that it never explained how or when taxable income would be clearly reflected.

Despite the repeated attempts in the various draft regulations to place restrictions on the use of completed contract and/or percentage of completion, the Treasury Department eventually determined that no such restrictions were needed. This decision, we believe, was premised on the fact that these methods had been in the regulations for so many years and had clearly reflected taxable income for so long that any change for tax purposes could not be based upon a clear reflection of income stadard. Thus, the final regulations, issued on January 14, 1976, reflected not only a careful and thoughtful decision to extend the use of the completed contract method but also a decision to put to rest any question regarding the clear reflection of taxable income. Now, some six years later, the clear reflection issue as it relates to the completed contract method once again has surfaced.

The obvious starting point in determining whether the completed contract method is a good or bad method of accounting from a tax accounting standpoint is to test it against the theoretically "best method." We have no doubt that the Treasury Department and Internal Revenue Service generally would view the accrual method as being the "best method" of accountng for tax purposes—not the accrual method CPAs use under GAAP, but rather the accrual method under the regulations of sections 451 and 461 of the Code with the familiar "all events test."

Under the "all events test," income and expenses accrue when all events have occurred to fix the right to receive the income or the obligation to pay the expense and the amounts can be determined with reasonable accuracy. The accrual method of accounting originated as a financial accounting concept and thus originally was adopted by Congress as an acceptable method because of its pervasive business use.

The "accrual method" as used today for income tax accounting purposes is a product of judicial and regulatory refinements.

It is interesting to note that the completed contract method for long-term contracts directly parallels the "tax accrual method." Taxable income or loss "accrues" under the completed contract method when all events occur to determine that income or loss under a contract—that is, when it is completed and accepted. Likewise, expenses are not recognized until the subject matter of the contract is completed—similar to the inventory accounting rules under the accrual method. Viewed in this light, the completed contract method properly matches income and expenses under the "all events test."

The Treasury Department proposals, rather than recognizing the symmetry between the completed contract method and the theoretically best method of tax accounting (accrual method) in terms of clearly reflecting income, choose the route of attempting to rely on an allowable, but not required, GAAP concept (percentage of completion) to make it appear that the completed contract method is a poor measure of taxable income for long-term contracts.

Implied preference for percentage of completion method

The Treasury release, in describing current law relating to the optional long-term contract methods, concludes that the percentage of completion method yields a better measure of taxable income than the completed contract method. The stated reasons for this conclusion are that "the percentage of completion method recognizes that income is earned over the course of a long-term contract and because it provides for a better matching of income and expense." The release goes on to state that conceptually, the percentage of completion method is the method of accounting for long-term contracts that best reflects the taxpayer's income. Thus, the release implies that current tax law contains a preference for the percentage of completion method.

This is not an accurate description of current law. The Internal Revenue Code and underlying regulations permit the use of either the percentage of completion method or the completed contract method with no implication that one method is better than the other in terms of clearly reflecting taxable income. Indeed, the Internal Revenue Service consistently has permitted taxpayers to adopt or change to either of the long-term contract methods and quite properly never has stated a preference for either method. The Internal Revenue Service reaffirmed its position as recently as March 10, 1981, in Private Letter Ruling 8140001, when it concluded that the percentage of completion method could not be imposed on a taxpayer by the Commissioner even if the taxpayer's method was found to not clearly reflect income. The Internal Revenue Service, citing *Magnon* v. *Commissioner*, 73 T.C. 980 (1980), in theory, concluded that, if the Commissioner could force a taxpayer to change its method of accounting to an elective method, the taxpayer had the right to elect which of the various elective methods of accounting it would use. In other words, the IRS refused to imply that one elective method (percentage of completion) was better than another (completed contract).

It is our view that the preference for percentage of completion expressed in the Treasury Department release should be promptly corrected so that Internal Revenue Service employees are not misled into raising invalid issues in examinations of taxpayers.

Relationship with GAAP

The Treasury proposal (Reasons for Change) opens with the statement that the completed contract method permits income to be deferred for tax purposes long after payments are received and long after income is deemed earned according to standard accounting practices (presumably meaning GAAP). This statement is in error.

Without any explanation or analysis, this statement assumes that the completed contract method is not generally accepted under GAAP and that it therefore is not a proper method of accounting for Federal income tax purposes. The statement furthermore assumes that GAAP requires earlier income recognition and that therefore the completed contract method improperly defers income for Federal income tax purposes. The proposal attempts to use GAAP to justify an acceleration of income, but does not attempt to follow GAAP in determining when contract costs should be deducted in arriving at gross income and/or taxable income.

The implication that the completed contract method is not acceptable under GAAP is not true. Many contractors, particularly smaller ones, continue to use the completed contract method in financial statements that are prepared in conformity with GAAP. Accounting Research Bulletin No. 45, "Long-Term Construction-Type Contracts," is the governing authoritative literature for financial statement report-

ing, and it allows use of either the completed contract method or the percentage of completion method. Statement of Position 81-1, "Accounting for Performance of Construction-Type and Certain Production-Type Contracts," strongly recommends use of the percentage of completion method in most cases. However, Statements of Position, by definition, include only recommendations. They are published by the AICPA, which no longer has authority to promulgate authoritative accounting literature; that authority was ceded to the Financial Accounting Standards Board (FASB) in 1973.

The FASB addressed SOP 81-1 in its recently issued Statement of Financial Accounting Standards (SFAS) No. 56. IN SFAS 56, the FASB designated the recommendations in SOP 81-1 as preferable accounting practices but only for the purpose of justifying voluntary financial statement accounting changes. This is the same approach that the FASB has taken on many AICPA recommendations issued since the FASB became the authoritative standard-setting body. This merely means that, under GAAP, enterprises cannot change to accounting methods that are different from the methods recommended in those AICPA documents that have been designated as preferable. However, enterprises are not required to change at all. Thus, the financial statements of contractors that continue to use the completed contract method are in conformity with GAAP.

At some time in the future, the FASB intends to extract the recommendations in SOP 81-1, subject those recommendations to due process, and consider issuing them in a FASB statement. Also, the FASB is in the process of establishing a broad framework of accounting principles, which is referred to as the "Conceptual Framework." One of the projects in this process deals with the fundamental issue of revenue recognition. Until that project is completed, it is very much unclear whether the percentage of completion method, the completed contract method, both, or perhaps neither will be considered to be the best method of measuring a contractor's GAAP income in the future.

The references to GAAP to imply that the completed contract method is unacceptable for purposes of measuring a contractor's taxable income is an invalid argument. It is invalid both because the completed contract method is acceptable under GAAP and, more importantly, because the conformity of tax law to GAAP is not appropriate.

Elimination of other permissible methods

We believe the proposed legislation to eliminate the use of the completed contract method and allow only the percentage of completion method or progress payments method is not appropriate. The proposal effectively eliminates not only the completed contract method but also prevents a contractor from using either the cash or the accrual method of accounting. The Treasury has given no explanation of why the cash or accrual methods no longer would be appropriate but rather sweeps all contractors into the new methods. There is no sound reason for prohibiting a contractor from using either cash or accrual and, as mentioned previously, the accrual method is the one method Treasury has preferred for taxpayers outside of the construction industry for years.

The problems a long-term construction or manufacturing contractor faces in using the accrual method of accounting are no different than those faced by any other taxpayer involved in the manufacturing business. The long-term manufacturing taxpayer must account for its sales in exactly the same manner as the non-long-term manufacturer, and work-in-process inventory accounts must be maintained to reflect accurately the timing of the taxpayer's expenses. Now, regardless of the commonality of problems between all types of contractors and other taxpayers, the Treasury is seeking to deny two widely recognized and accepted methods of accounting because of the distortion of income problems apparently perceived in the nature of the contracting business.

By urging that the accrual method should continue to be permitted, we do not mean to imply that contract retainages should be accrued. On the contrary, we believe Rev. Rul. 69-314, 1969-1 C.B. 139, should continue to apply so that retainages do not accrue until the subject matter of the contract is completed and accepted by the other contracting party.

Required methods

The Treasury proposal, in eliminating the use of the cash, accrual, and completed contract methods, requires the percentage of completion method or the progress payments method. Neither of these methods should be imposed legislatively upon contractors. Rather, contractors should be given the same opportunity afforded other taxpayers to elect and use whichever method of accounting they prefer.

Percentage of completion method.—The percentage of completion method, although being an acceptable method of accounting for Federal income tax purposes, does not best reflect a contractor's taxable income as Treasury has concluded. The percentage of completion method lacks the precision of the completed contract method and is not based on an "all-events" standard.

It is well established that both the Treasury and Internal Revenue Service do not readily accept or encourage methods of accounting for tax purposes that are based on estimates of income and expenses. The percentage of completion method is such a method and permits income to be estimated based on the percentage of work performed. To the extent the percentage of completion method is, in fact, an "estimation" method, it is a departure from the tax "all-events" concept and simply cannot be described as a preferable method for tax purposes.

Progress payments method.—Perhaps the most alarming aspect of the Treasury proposal is the second alternative—the progress payments method. It is questionable whether the progress payments approach should be elevated to the status of an accounting method because it departs from basic tax accounting and fundamental tax equities. However, for purposes of this memorandum, we will assume that it is an accounting method. The progress payments proposal is a wholly inappropriate method upon which to compute taxable income because (1) it treats progress payments as income, (2) it is a positive income flow concept, (3) it uses a contract-by-contract approach, and (4) it requires loan proceeds to be included in gross income.

Progress payments as income

The progress payments method requires progress payments to be included in income when the right to receive the payments arises. This concept has overtones of an all-events test, but it assumes that part of any progress payment represents an element of profit and to that extent currently taxes the profit element. The notion that a profit element always is included in a progress payment is incorrect. By definition, a contractor's profit on a contract is the difference between the contract price and the costs incurred in performing the contract. A contractor has no assurance and, in many cases, cannot estimate reliably what, if any, portion of progress payments received in a current year represents profit because until the contract is completed, the costs incurred to complete will not be known with any great degree of accuracy. However, Treasury has chosen to disregard the realities of the situation and tax any progress payment in excess of current costs without giving any explanation of how the progress payments represent ultimate profit.

The progress payment method assumes that a progress payment is income notwithstanding the fact that there is a concurrent obligation to perform under the contract with the contractor not being assured that it will have a profit on the contract if it does perform or whether the contractor can retain the progress payments if it does not perform. It was this same lack of certainty that prompted the Treasury to revise its rules for deferring advance payments for goods and services so that such advances could be earned as the services were rendered or goods were delivered.

Positive income flow concept

Under the progress payments concept, if expenses equal progress payments, there is no income; if progress payments exceed expenses, there is current taxable income; but if expenses exceed progress payments, there is no allowable deductible loss. To prohibit a contractor or any taxpayer from being able to offset its expenses against its revenue with any excess expenses resulting in a net operating loss available for carryback purposes, is inconsistent with basic tax concepts. There is no justification for a method of accounting that requires only expenses to be deferred when expenses exceed income but requires current recognition of income (if progress payments are income) when income exceeds expenses.

Contract-by-contract approach

Another problem with the progress payments concept is the contract-by-contract approach adopted in the proposal. Again, Treasury is placing an unfair restriction on contractors by effectively denying a contractor the right to offset excess costs over progress payments on one contract against the excess progress payments over costs on another contract. It is inequitable to deny a taxpayer the ability to file a tax return reflecting the results of all of its operations. A contractor with excessive costs on one contract is in no position to pay taxes on another contract simply because the second contract has progress payments in excess of costs. The excess progress payments represent nothing more than an advance by the other contracting party for the costs that must be incurred by the contractor in the future. The excess costs over progress payments on the other hand represent out-of-pocket costs by the

contractor whose deductibility should not be limited. Thus, this aspect of the proposal disregards the economic realities of the situation and has the effect of placing each contract in a separate taxpaying entity.

Treatment of loans

The proposal to treat certain loan proceeds as income under the progress payments method is equally foreign to any previous equitable tax concept. As a starting point, it must be recognized that a contractor has to finance its operations in some manner. The financing is typically obtained either through advance payments or loans with the contract often securing the loan. The loans are bona-fide arms-length arrangements with third party creditors in many instances and are designed for the very purpose of financing construction. Now the loan proceeds will constitute income to the contractor under the progress payments method.

It is a well-established tax principle that a balance sheet item such as a liability to a lender does not create income. On the contrary, loan proceeds historically have been viewed by Treasury and the Congress as being valid business indebtedness and by requiring that these proceeds be treated as income for tax purposes departs from historical tax accounting. A borrowing by a contractor to finance construction is no different than a borrowing by any other taxpayer to finance its operations. In no other aspect of the economy are borrowings deemed to be income (nor should they be) and, as noted previously, this position is totally contrary to the tax accounting rules regarding the treatment of advance payments for accrual method manufacturers, merchandisers, and providers of services.

Costing rules

Both the legislative and the regulatory proposals contain revisions of the present costing rules contained in section 1.451-3(d)(5) of the Income Tax regulations for long-term contracts. However, these new costing rules represent a radical departure from the existing rules and negate many of the rules in other sections of the Internal Revenue Code simply because the contractor is engaged in some aspect of the long-term contracting industry.

Present costing rules

The existing regulations contain a list of both direct and indirect costs that must be included in determining the costs allocable to a long-term contract. The regulations also list a series of costs that are not required to be included in long-term contract costs. As noted previously, when the long-term contract regulations were revised in 1976, the purpose of establishing costs either to be included in or excluded from long-term contracts was to embody in regulations what was existing case law. The case law relied on by Treasury in 1976 has not changed since that time. The resulting costing rules were not an off-handed resolution of the problem by Treasury but rather the result of a five-year process that also was associated with the full absorption inventory costing rules under section 1.471-11 of the regulations for inventory accounting. The resulting long-term contract costing rules recognized that not all costs incurred by a contractor should be allocated to long-term contracts and that certain costs should be expensed currently because not every expense incurred by a contractor relates to long-term contracts.

New costing rules

The legislative and regulatory proposals now being advanced by Treasury focus on only the costs that do not have to be allocated to long-term contracts under current regulations and seek to require deferral of additional costs by limiting those that are currently deductible. The costs presently permitted to be deducted currently by long-term contractors parallel the "category ii" costs in section 1.471-11 of the regulations. Those costs do not have to be included in inventory by manufacturers.

The most notable deletions from and modifications to the existing list of currently deductible costs are as follows:

(1) Bidding expenses;

(2) Other distribution expenses;

(3) Interest;

(4) General and administrative expenses and officers' compensation attributable to the contractor's activity as a whole;

(5) Research and experimental expenses;

(6) Percentage depletion in excess of cost depletion and excess tax depreciation and amortization over financial statement depreciation; and

(7) Miscellaneous costing items, such as current service pension costs and other employee benefits and costs attributable to rework labor, scrap and spoilage.

All of the above costs are being completely deleted from the list of currently deductible items or their deductibility is being restricted severely. Our comments on each of these specific items follows.

Bidding expenses

The proposed rule would allow bidding expenses to be deducted currently only if the expense relates to a contract that is ultimately not awarded to the contractor. Although the proposal is not entirely clear, presumably Treasury means that if a contractor incurs expenses in year 1 in bidding on a contract but the contract is not awarded until year 3, the contractor must wait until year 3 to determine when the bidding expense is deductible. Such an approach does not result in a current deduction in the year the expenses are incurred but rather results in a deferred expense that can be deducted in some future year.

Such a wait-and-see attitude on the part of Treasury for deduction of expenses does not aid in simplifying an already complex tax system and can only result in an increased amount of paperwork with no significant increase in Government revenues. If a contractor incurs expenses prior to being awarded a contract, those expenses represent an at-risk amount on the part of the contractor. Such expenses are not financed by the other contracting party but rather represent an expense incurred to acquire business. As such, no limitation should be placed on a contractor's ability to deduct such expenses.

Other distribution expenses

These expenses apparently are being dropped from the list of currently deductible items as a result of the fact pattern in Rev. Rul. 81-208. However, there is no need to delete such expenses for a long-term contractor. A manufacturing contractor's other distribution expenses are very similar to those expenses incurred in other manufacturing settings (and currently deductible under section 1.471-11) and therefore should not be treated differently. Any problems associated with the current deduction of such expenses should be addressed through the revenue ruling process similar to Rev. Rul. 81-208.

Interest

Interest, which is required to be deducted in the year paid or incurred under section 163 of the Code, no longer would be currently deductible if the taxpayer has long-term contracts. If this denial of an interest deduction is coupled with the progress payment proposal to currently tax loans as income, it places the contractor in the untenable situation. The contractor would be required to report the loan proceeds as income but would be denied an interest deduction for interest that has been paid or incurred on the loan if the contract costs exceed the loan proceeds. If the contractor has incurred interest on valid business indebtedness, it should be no worse off than any other taxpayer who incurs interest expense and deducts it as incurred. The Treasury proposal completely ignores the fact that contractors do business in the same manner as other industries and financing must be obtained. Therefore, the interest expense incurred to finance the construction or manufacture of a project or product should be a current deduction.

General and administrative expenses—officers' compensation

The existing long-term contract costing rules recognize that not all personnel expenses incurred by a contractor relate to long-term contracts. For this reason, the current rules permit a current deduction for general and administrative expenses, including payroll expenses and legal and accounting fees, and officers' salaries that benefit the contractor's activities as a whole.

To require deferral would do nothing but add an additional, often inconsequential step, to a contractor's recordkeeping with no significant amount of revenue being generated. This aspect of the proposal would result in arbitrary allocations of these various expenses among the taxpayer's contracts and would do little, if anything, in aiding the clear reflection of income.

The Treasury proposal is not cognizant of this fact but requires deferral of all such costs simply because the taxpayer is engaged in long-term contracting. Additionally, the proposal would seem to require deferral of these costs even if the taxpayer has only minimal long-term contract activity.

This aspect of the proposal neither can be justified nor defended. Some recognition must be given of the fact that not all costs incurred relate to long-term contracts.

Research and experimental expenses

Section 174 of the Code permits a taxpayer either to deduct currently or to amortize over five years expenses incurred for research and experimentation. The Economic Recovery Tax Act of 1981 (ERTA) authorized a special tax credit for such expenses in an attempt to encourage research.

The Treasury proposal now is attempting to deny the benefits of section 174 if the expenses can be associated with long-term contracts. Such a denial can have only a deleterious effect on the research that is performed in this country, particularly in connection with research intended to benefit our national defense. Taxpayers incurring such expenditures are and should continue to be permitted to currently deduct or amortize such amounts, and their overall method of accounting for income should not result in a denial of such methods.

Depreciation and percentage depletion

One of the most sweeping revisions made by ERTA was reform of our depreciation system. The accelerated cost recovery system was viewed as an incentive needed to spur and revitalize our nation's sagging economy. Accelerated depreciation and percentage depletion were viewed in much the same light when they were originally enacted. The short-term revenue losses were viewed by the Congress as being totally acceptable because significant long-term growth of the economy was viewed as a much more desirable goal.

The treasury Department now is attempting to take back from contractors what it fought so long and hard for only one year ago. The need for accelerated depreciation or recovery through sections 167 or 168 is even more important today than it was when the provisions originally were enacted. To dany the contractors the ability to deduct these accelerated amounts of depreciation, cost recovery, or depletion for tax purposes will not aid in revitalizing our nation's economy but rather will force the long-term contracting industry to finance, in effect, through deferred expenses a large part of last year's business tax cuts. These cuts were designed to spur growth, not to raise taxes.

Miscellaneous costing items

Current service pension costs, other employee benefits, and costs of scrap and spoilage also are being targeted by Treasury for deferral. All of these items are specifically covered by the "category iii" inventory costing rules for manufacturers in section 1.471-11 of the regulations. As such, manufacturers either can include or exclude such costs for tax purposes depending on their financial statement treatment.

Costs, such as scrap and spoilage, if incurred at all, generally are incurred by manufacturing contractors and such contractors should be no worse off than any other manufacturer. To require deferral, rather than permit it, serves no justifiable purpose. A manufacturing contractor, on almost every job, will incur these costs in one form or another, and many of these costs (scrap and spoilage) are the types of costs that cannot reasonably be avoided despite the best efforts of the contractor. As such, they are another cost of doing business and are not related to the end product to be delivered under the contract.

Accrual shipment and accrual acceptance methods

Another aspect of the Treasury proposal that we believe is in error is the contention that the "accrual shipment" or "accrual acceptance" method does not clearly reflect income for tax purposes. The Treasury's intent in this aspect of the proposals is not clear, and our comments are based upon our interpretation of the proposals. The accrual shipment and acceptance methods are used by manufacturers, and are distinguishable from the completed contract method in that, under both of these methods, a taxpayer uses the overall accrual method and maintains a standard inventory accounting method. Since inventory is maintained, the taxpayer may use any acceptable inventory accounting method, such as FIFO, LIFO, etc.

Under the proposals, a contractor who uses either the accrual shipment or acceptance method would have to use the above new contract costing rules, and apparently would be denied the right to use an inventory method, such as FIFO or LIFO.

Recognizing revenue upon shipment of goods or acceptance of the goods by the purchaser is fully consistent with the "all events test" as discussed above for other accrual method taxpayers, including manufacturers. Therefore, it is not appropriate to deny a taxpayer, who is a manufacturer and contractor, the right to use the same inventory costing and valuation methods available to all other manufacturers.

Accrual shipment or accrual acceptance taxpayers subject to new costing rules

Other major problems with the accrual shipment and acceptance proposal is its scope and potential complexity. Regarding the scope, numerous contract manufac-

turers presently are not entitled to use a long-term contract method because the subject matter of the contract is neither unique nor takes more than 12 months to complete (section 1.451-3(b)(1)(ii)). Thus, such taxpayers are required by current regulations to use the accrual/inventory accounting rules. The Treasury proposal apparently would require that these manufacturers, who have manufacturing contracts, account for contract costs and related income pursuant to the new methods being advocated even though these manufacturers were not entitled to use a long-term method in the first instance.

Regarding the potential complexity, one need only consider the following example. Using the example contained in section 1.451-3(b)(1)(ii) of the regulations, assume a taxpayer manufactures folding chairs. Present regulations prohibit use of the completed contract method, so the taxpayer accounts for sales when the chairs are shipped, and maintains inventories pursuant to section 1.471-11. Assume further that the taxpayer receives a contract to manufacture 15,000 folding chairs, and also manufactures an additional 25,000 chairs without a prior contract solely to maintain an inventory of chairs held for sale.

If one follows the Treasury proposal, the contract for 15,000 chairs would be subject to the new section 451 costing rules while the 25,000 chairs would be subject to the section 471 costing rules. Treasury achieves this result even though the 40,000 chairs would be manufactured by the same employees, using the same materials and equipment, being paid the same wage rate, and being subject to the same indirect costs. Such s system of cost allocation is incomprehensible.

STATEMENT ON BEHALF OF PETERSEN, HOWELL & HEATHER, INC., AND ITS PARENT, PHH GROUP, INC., BY DALE W. WICKHAM, EDWARD O. CRAFT, AND JULIE W. DAVIS OF PIPER & MARBURY, COUNSEL

INTRODUCTION

This statement is submitted on behalf of Petersen, Howell & Heather, Inc., a company headquartered in Hunt Valley, Maryland, which has been engaged in the management and leasing of fleets of automobiles and trucks on a nationwide basis for over 30 years.

The purpose of the statement is to urge the Committee to address, by way of legislation, a critical problem now confronting the motor vehicle fleet leasing industry. The legislation in question, a draft of which is appended to this statement, would prevent retroactive recharacterization for tax purposes of certain binding lease contracts that include a terminal rental adjustment clause. It would also require that any prospective changes in the tax treatment of such leases be effected either by Congressional legislation or by formal Treasury Department regulations promulgated only after a policy-level study, prior notice, and an opportunity for full public hearing.

SUMMARY

Under present law, an automobile or truck used in a trade or business or for the production of income is depreciable property and is eligible for the investment tax credit. Generally, any depreciation deduction or investment credit allowable in a taxable year for a leased auto or truck is claimed by the lessor. In a National Office Technical Advice Memorandum (LTR 8019120), first published in May 1980, the Internal Revenue Service adopted a new position that the risk of ownership shifts to the user when a lease agreement contains a terminal rental adjustment clause. Under those circumstances, the transaction will be treated by the IRS as a conditional sale rather than as a true lease. Under the Service's position, the taxpayer contractually designated as the "lessor" is not allowed to claim any depreciation deduciton or investment credit for the "leased" property. Moreover, the Service also stated in the Technical Advice Memorandum that it would not exercise its discretionary power under Code Section 7805(b) to apply its new position on a prospective basis only.

Terminal rental adjustment clauses have been used by the motor vehicle fleet leasing industry for more than 30 years to insure that rental payments reflect the true cost of using the vehicle during the lease term. These clauses provide a means of adjusting the total rental price of a leased vehicle, either upward or downward or both, at the end of the lease or actual use by the lessee to reflect the amount realizable by the lessor upon sale or other disposition of the vehicle.

The presence of such clauses in the standard industry lease has for three decades protected the lessor's interest in the salvage value of his fleet against neglect or

abuse by lessees. Similarly, when applicable to both the lessor and lessee, a rental adjustment clause enables a lessee to reap the rewards of turning in a vehicle in such good condition that its resale value exceeds the parties' original salvage value estimate.

Notwithstanding the important business purposes served by rental adjustment clauses and its own long-standing audit position that recognized contracts with such clauses as true leases, the Service adopted its new position without benefit of any prior notice to Congress or to the public and without any public hearings allowing interested parties to express their views. Moreover, despite a subsequent ruling by the United States Tax Court in the April 1981 *Swift Dodge* case [1] that the new Service position is wrong, the IRS continues to apply the new position retroactively in auditing selected motor vehicle fleet lessors.

As will be discussed more fully below, this is a clear case where retroactive application of a change of position concerning the tax effects of a contract binding on the parties ought not be permitted. Prompt legislative action is therefore necessary to insure that no changes in the tax treatment of motor vehicle leases with terminal rental adjustment clauses occur absent a change in the law or a prospective change in Treasury Department regulations after adequate notice and hearings.

THE NEED FOR LEGISLATIVE ACTION

The Internal Revenue Service's new position concerning the effect of terminal rental adjustment clauses in motor vehicle fleet leases is, we believe, incorrect as a matter of law. The Supreme Court in 1978 defined the proper legal standard for determining whether a transaction is to be treated as a lease or as a sale for federal income tax purposes as follows:

". . . [W]here . . . there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes." [2]

The legislation we are proposing, however, is not addressed to the substantive merits of this question. Instead, we are seeking to avoid the almost inestimable harm and unfairness which would result from the retroactive application of the Service's new position, whether or not that position is ultimately rejected by the courts.[3] In addition, we are also seeking to insure that future changes in the tax treatment of motor vehicle leases with terminal rental adjustment clauses will be effected only by express Congressional authority or by prospective Treasury Department regulations.

The importance of the vehicle leasing industry in the U.S. economy

The U.S. vehicle leasing industry meets the needs of a number of U.S. industries for large quantities of motor vehicles. Firms in the vehicle leasing industry purchase large fleets of vehicles from U.S. motor vehicle manufacturers or dealers and lease such fleets to other commercial or industrial firms. The economies introduced by the vehicle leasing industry result in a highly efficient mechanism for distributing several hundred thousand cars and trucks produced in the United States each year.

The vehicle leasing industry plays an extremely significant role in the United States economy. It has been estimated that there were over 4.5 million vehicles under lease in the United States during 1980. In 1979 and 1980, vehicles purchased for lease constituted 15.5 percent and 16.0 percent respectively, of the total output

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[1] *Swift Dodge* v. *Commissioner*, 76 T.C. 47 (1981), appeal docketed, No. 81-7440 (9th Cir., May 15, 1981).

[2] *Frank Lyon & Co.* v. *United States*, 435 U.S. 561, 583-84 (1978).

[3] We believe, however, that judicial rejection of the IRS position is inevitable. The Service's test for determining whether a transaction involving a terminal rental adjustment clause is a true lease or a conditional sale has not only been rejected by the Supreme Court in the *Lyon* case, supra, note 2, and by the Tax Court in the *Swift Dodge* case, supra, note 1, but is also at odds with several other recent cases. In *Northwest Acceptance Corp.* v. *Commissioner*, 58 T.C. 836 (1972), aff'd 500 F.2d 1222 (9th Cir. 1974), and *Lockhart Leasing Co.* v. *Commissioner*, 54 T.C. 30 (1970), aff'd 446 F.2d 269 (10th Cir. 1971), certain of the leasing transactions at issue were structured so as to have the same economic effect as a rental adjustment clause. In both cases, the courts found that the transactions constituted true leases for federal income tax purposes.

of the domestic automobile manufacturing industry. Substantially all vehicles purchased for lease by the vehicle leasing industry are domestically manufactured.

Moreover, in times of economic recession, purchases of domestically produced vehicles by the vehicle leasing industry do not decline as fast as purchases of vehicles generally decline under those conditions. For example, the domestic car purchases by major industry members actually rose sharply during the period of precipitous decline in auto sales beginning in 1979.

The importance of the terminal rental adjustment clause in the standard industry lease

The terminal rental adjustment clause is a mechanism designed to meet important business requirements of the fleet vehicle leasing industry. As of 1980, over 60 percent of the automobiles and trucks held under fleet leasing arrangements were subject to a standard industry lease agreement which contained such a clause.

A traditional expectation of the lessor of property is that, at the expiration of the lease, the property will be returned to him in a condition such that its residual value roughly approximates the residual value that was anticipated at the inception of the lease. The residual value of a leased vehicle is greatly influenced by the amount of use and the quality of care that it receives while under lease.

It is not administratively or competitively feasible, however, for lessor firms to police the use and maintenance of their vehicles while under lease or to determine in advance those lessee firms likely to operate the vehicles in a manner inconsistent with an acceptable residual value. Thus, fleet lessors have come to rely on the terminal rental adjustment clause as a means of reflecting the actual residual value of a leased vehicle when it is surrendered by the lessee at the end of actual use or the end of the lease term as the case may be.

When a lessee turns in a neglected, poorly maintained, vehicle which brings in less than its projected residual value, a terminal rental adjustment clause enables the lessor to recoup the deficiency from the lessee who is appropriately penalized by a rental adjustment in favor of the lessor firm. Correspondingly, the lessee who turns in a well-maintained vehicle which is worth more than the projected residual is rewarded under the terms of a terminal rental adjustment clause by a refund of a portion of the rent paid. The terminal rental adjustment thus insures that the rent charged the lessee firm reflects the actual cost of using the vehicle during the term of the lease.

Clearly the use of terminal rental adjustment clauses is based on sound economic principles which are entirely independent of tax avoidance considerations. The effect of using such a rental adjustment clause is to lower the overall cost of the leasing transaction. This is because (i) the total rent paid is based on a known—rather than an estimated—cost, and (ii) costs are borne by the party best able to control them—the lessee. It is not surprising, therefore, that the efficiencies and cost-savings associated with thee clauses have led to their widespread use as indicated above.

The harmful economic effects of the new IRS position

The new IRS position that leases containing terminal rental adjustment clauses are to be treated as conditional sales for federal tax purposes threatens to disrupt the smooth functioning of the motor vehicle industry at a time when our nation's entire economy, and particulary the automobile industry, is already on shaky ground.

First, the cost of delivering transportation capacity to U.S. industry would be increased. Allocation of the federal income tax incidents of the standard lease transaction is a crucial factor in determining the amount of rental charge. Under the traditional industry practice, the lessor firm is entitled to depreciation deductions and investment credits with respect to leased vehicles. The tax deferral inherent in the availability to the lessor of depreciation deductions and investment credits at the beginning of a lease period permits the lessor to earn a satisfactory real cash return on its investment at a lower rental charge than would have been required had the depreciation deduction and investment credits belonged to the lessee. The rent charged by a lessor firm would have to increase in order to replace the cash flow lost as a result of the Service's allocation of depreciation deductions and investment credits from the lessor to the lessee firm.

Second, application of the new IRS position to completed transactions could result in the economic destruction of some firms in the vehicle leasing industry, the overwhelming majority of which are affiliated with car dealerships already in serious economic distress. The industry is highly competitive. Profits are earned by applying relatively low profit margins to relatively high volumes of business. The typical firm has a high debt to equity ratio. Accordingly, past standard industry leases were

negotiated with the expectation that depreciation deductions and investment credits would be available to the lessor firm. The enforcement of deficiencies based upon the theory that such deductions and credits do not belong to the lessor could well bankrupt some firms in the industry.

Third, general application of the new IRS position would disrupt an established system of distributing automobiles and trucks and would adversely affect the U.S. automobile manufacturing industry and the vast majority of U.S. automobile dealerships. This is a particularly shocking IRS policy decision at this time in the life of the Nation. In late 1980, new car deliveries had reached a 22-year low, car production was down to the 1955 level and manufacturers and dealers were in financial distress. Those conditions persist. Manufacturers have reported that the only consistent element in the automobile marketplace is vehicle leasing, where sales are continuing at a normal level while all other sales are sharply down. The serious national economic problem affecting automobile manufacturers, dealers and leasing companies would be made worse at this time by disrupting the customary leasing mechanism and inevitably slowing down sales for leasing purposes.

The incentive effect of the investment tax credit and the accelerated cost recovery system (ACRS) recently enacted by Congress will be diluted or defeated. The major purpose of the new system is to provide incentives to taxpayers engaged in trade or business to purchase certain kinds of income-producing property, including automobiles and trucks. The IRS position undermines the incentive effect of these provisions for motor vehicle fleet lessors and lessees by interposing a cloud of uncertainty with respect to the income tax treatment of transactions commonly engaged in for more than 30 years.

Unfairness of applying the new IRS position retroactively

The undesirable consequences of the Service's new position are compounded by the inherent unfairness of its application. The Service has made clear its intent to apply its new position retroactively. This retroactive application is occurring notwithstanding the fact that standard industry practices and contracts have evolved over a number of years based in large part on IRS audit actions and IRS decisions not to act during that time. In light of this administrative history, the Service should not now be permitted to reverse itself and apply that new position retroactively.

The question whether the lessee or the lessor should be treated as the owner of the property subject to the lease has been an issue in federal tax law at least since the 1930's.[4] Yet despite the fact that it has known for many years that leases with terminal rental adjustment clauses were developing as standard practice in the vehicle leasing industry, the Service has never—to this date—published an official, generally applicable, statement of its position with respect to the federal income tax treatment of such leases. While it is generally assumed that Technical Advice Memorandum LTR 8019120 represents the current views of the IRS National Office, this document is officially treated as a private ruling, directed to the facts of a particular case, and as such, does not represent an authoritative announcement of the Service's position such as a revenue ruling or revenue procedure would.[5]

We do not mean to suggest that the IRS may never take a position in litigation that is not based on previously published official statements of its views. In this particular case, however, the absence of any such published statements combined with the three specific factors discussed below reveal such a clear failure to provide proper administrative guidance to an entire industry that retroactive application of the new administrative position is clearly unreasonable and inequitable.

In the first place, on at least two occasions since the mid-1960's, the Service has specifically declined to respond publicly to submissions by certain industry representatives seeking an authoritative resolution of this question. Regardless of what the private reaction to these submissions may have been, the fact is that no public statement was made to warn lessors that the Service might take a position contrary to that urged by the industry. This failure of the IRS to act obviously contributed to the assumption that no challenge to the prevailing treatment of leases with rental adjustment clauses was likely to be forthcoming.

Secondly, prior to 1975 when Rev. Proc. 75-21 was published,[6] lessors could not, in general, obtain private letter advance rulings from the IRS on the question whether

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[4] *See Helvering* v. *Lazarus*, 308 U.S. 252 (1939).

[5] It should be noted that the Technical Advice Memorandum was made public pursuant to Internal Revenue Code Section 6110, which provides specifically, that such documents "may not be used or cited as precedent," and this warning is physically stamped by the IRS on the face of the document itself.

[6] 1975-1 C.B. 715.

a lease would be viewed as bona fide for federal tax purposes. Moreover, the conditions set forth in Rev. Proc. 75-21 are so specific and highly restrictive that most companies whose normal business activity is leasing motor vehicles and other types of equipment cannot avail themselves of the Service's advance ruling procedures. Yet there is no question but that many transactions which do not satisfy the conditions for obtaining an advance ruling are in every legal and economic sense true leases. Indeed, Rev. Proc. 75-21 itself states specifically: "... These guidelines do not define, as a matter of law, whether a transaction is or is not a lease for Federal income tax purposes and are not intended to be used for audit purposes...."[7]

Perhaps most compelling, during the many years of silence from the National Office, vehicle lessors relied on the one affirmative indication of the Service's position which they did receive. The validity of leases containing terminal rental adjustment clauses was simply never challenged on audit. The major leasing companies were audited every year during this period, while others were reviewed on a more or less regular schedule. And even though in many instances revenue agents proposed adjustments which related to the method of computing depreciation on leased vehicles—which adjustments were therefore necessaryily premised on the assumption that the lessor was the owner of the vehicles—the question whether a lease with such a clause resulted in a conditional sale of the vehicle to the lessee was never raised.

Finally, it is important to note that retroactive application of the Service's position will necessarily divide the auto leasing industry into two classes: those members of the industry against whom the IRS' position is enforced and those against whom it is not enforced whether by reason of inadequate audit coverage, running of the statute of limitations, or differing views of examining agents as to the proper application of the law. Such a result would not only be unfair, in that it applies different treatment to similarly situated taxpayers, but it also would introduce distortions in the structure of the industry's market by conferring an unfair competitive advantage on those firms against whom the policy is not or cannot be enforced.

DESCRIPTION OF THE LEGISLATION PROPOSED

The legislation which we are proposing concerning the tax treatment of terminel rental adjustment clauses in motor vehicle fleet leases is not the first legislative response to the new IRS position. Following publication of the IRS Technical Advice Memorandum (LTR 8019120), the then Chairman of the Committee of Ways and Means, Mr. Ullman, introduced H.R. 8073[8] and held hearings on it and other legislation in September 1980.[9] H.R. 8073 would have required the IRS to determine the tax treatment of automobiles and truck leases executed prior to January 1, 1981 without regard to the presence of rental adjustment clauses. This proposal was reintroduced in March 1981 as H.R. 2837[10] and, in May 1981, identical legislation was introduced in the Senate by Mr. Armstrong, of Colorado as S. 1111.[11]

Shortly thereafter in June 1981, Congressman Gibbons introduced legislation in the House which took a somewhat different, and in our view improved, approach from that taken in the earlier bills. Under Mr. Gibbons' bill, H.R. 3857,[12] legislative action by Congress would be required before the IRS could reclassify an automobile or truck lease either prospectively or retroactively because of the presence of a terminal rental adjustment clause.

Inasmuch as it is intended to achieve the same basic purposes as H.R. 3857, our legislation differs from the Gibbons bill in only two respects. First, it covers leases of all types of motor vehicles (including trailers). Second, it would allow prospective changes in the tax treatment of motor vehicle leases with terminal rental adjustment clauses to be effected not only by Congressional legislative action but also by formal Treasury Department regulations.

Need for procedural safeguards as well as policy level study and discussion prior to any prospective changes

In proposing this response to the new IRS position, we do not mean to suggest that we believe a change in the historic tax treatment of motor vehicle fleet lessors

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[7] Id.
[8] H.R. 8073, 96th Cong., 2d Sess. (1980).
[9] See Foreign Convention Tax Rules and Minor Tax Bills: Hearings Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, 96th Cong., 2d Sess. (Sept. 18, 1980).
[10] H.R. 2837, 97th Cong., 1st Sess. (1981).
[11] S. 1111, 97th Cong., 1st Sess. (1981).
[12] H.R. 3857, 97th Cong., 1st Sess. (1981).

is warranted, even on a prospective basis. To the contrary, we view our proposal, in accordance with the theory and result of the Tax Court decision in *Swift Dodge* and the other leasing cases discussed above, as declaratory of existing law. Therefore, our legislation is based on the premise that neither Congress nor the Treasury Department would consider any changes in the present law unless the Department has conducted a major policy level study of the economic and tax issues bearing on the question whether there is a sufficient reason to deny fleet lessors the depreciation deductions and investment tax credits otherwise allowed owner-lessors of depreciable business property. Our draft legislation would not require such a study. However, it would certainly contemplate that no change could be made without a thorough analysis of these issues.

Moreover, if such a study indicated a need for change, our legislation anticipates that any proposals for change to be effected at the administration level would be in the form of a major legislative regulation which would be developed by all interested policymakers within the Service, the Treasury Department and the Administration. Finally, our legislation would expressly provide that no such legislative regulation could be finally adopted until it had been considered in open, public proceedings in which, after due notice, opportunity was provided for comment and participation not only by affected business taxpayers but also by interested members and representatives of the public.

No significant revenue impact associated with proposed legislation

In urging the Committee to give favorable consideration to our legislative proposal, we want to emphasize that the bill should be viewed as revenue neutral. It seeks to preserve the historic tax treatment of leases with terminal rental adjustment clauses until changed either by Congressional legislation or by prospective Treasury Department regulations.

Were the IRS permitted to retroactively characterize vehicle leases with terminal rental adjustment clauses as conditional sales as it is now threating to do, then the tax benefits of vehicle ownership would for the most part be simply transferred (where the statute of limitations is not a bar) from the lessor to the business lessee. Treasury revenues would not be significantly affected by retroactive or prospective application of the Service's new position.

At the same time, our proposed legislation would eliminate very significant and costly administrative burdens for both the IRS and the vehicle leasing industry. A retroactive IRS reclassification of these leases as conditional sales would require adjustment of virtually every vehicle lessor's tax returns. The tax returns of business lessees (who presumably took tax deductions for rental payments) would also have to be adjusted retroactively, to eliminate rental deductions, and to include instead lessee claims for investment tax credit and depreciation allowance. Tremendous confusion in audit and compliance, and uneven application of IRS' position, would result from reclassification of these leases—not to mention the substantial costs to the Government which are connected with unproductive tax controversies and litigation on an industry-wide basis.

CONCLUSION

This legislative proposal relates to the "terminal rental adjustment clause" issue. It would prevent the Service from retroactively recharacterizing a transaction negotiated by the parties as a lease as a transaction other than a lease merely because the parties have included a terminal rental adjustment clause.

The terminal rental adjustment clause has existed for more than 30 years. It was developed and has actually served important business needs of the motor vehicle leasing industry. If the IRS desires to establish a rule that an agreement containing such a clause is not a true lease, it should ask Congress for appropriate legislation. Alternatively, it should ask the Treasury Department for legislative regulations which should not be promulgated until after a policy-level study is conducted and interested parties are afforded an opportunity to be heard. Any regulation resulting from such a process would be applied on a prospective basis only.

For the IRS to proceed in individual cases on a retroactive basis is disruptive of the market place. Individual taxpayers ought not be subjected to uneven application of the tax law for any period, much less retroactively. Retroactive application in individual cases under the circumstances involved in the terminal rental adjustment clause is unwarranted. It exemplifies unsound, unwarranted, and discriminatory action and it violates sound tax policy.

We urge that the Committee include the attached legislative proposal in the next piece of tax legislation reported out this session.

Attachment.

LEGISLATION TO PREVENT RETROACTIVE TAX RECLASSIFICATION OF A BINDING CONTRACT FOR LEASE OF A MOTOR VEHICLE

Insert at the appropriate place in the bill the following:

"Unless otherwise hereafter provided by statute or by prospective regulations (which may not be effective in respect of any contract entered into in any taxable year beginning on or before the date such regulations are published in the Federal Register) prescribed by the Secretary of the Treasury after notice and opportunity for public hearing, the treatment by any lessor of any motor vehicle (including a trailer) subject to a lease as property of a character subject to the allowance for depreciation shall not be disturbed for any taxable year (whether ending before or after the enactment of this Act) by reason of the presence in such lease of a terminal rental adjustment clause which permits or requires rental price to be adjusted upward or downward by reference to an amount realized by the lessor upon sale or other disposition of such property."

POWER SYSTEMS, INC.,
Schaumburg, Ill. April 23, 1982.

Hon. DAN ROSTENKOWSKI,
Chairman, House Ways and Means Committee,
Washington, D.C.

DEAR MR. ROSTENKOWSKI: The pending proposal to eliminate optional use of the "completed contracts method" for federal income tax reporting by construction contractors should not pass. While anyone directly involved with the regulations governing income taxation on contractors will agree that the "percentage completion method" is preferable whenever feasible, they must also agree that the original reasons for establishing the completed contracts method are still valid.

Nearly all long-term contracts are entered into with an original estimated gross profit. The fact that a great many of these projects run into trouble and actually end up with substantial losses can be proven, regrettably, by looking at the records of any and all long-term contractors. In today's economy, with the cost of money widly exceeding original estimates, with construction labor productivity taking a bigger nosedive than anyone could have predicted, with cancerous inflation outstripping even the most pessimistic forecasts of the past, estimating long-term contract costs is a crapshoot.

Many projects are completed with lower gross profit than originally estimated. Far fewer projects are completed with higher gross profit than originally estimated. Given this economic circumstance, eliminating the completed contracts method mill result in the collection of unfair windfall profits by the United States Government. While this may appear attractive to bureaucrats and legislators looking for ways to give the federal treasury a quick fix, its punitive effect on long-term contractors is without justification.

The goal of any change in the tax laws should be to improve the fairness of those laws. We all have to pay our fair share of government's cost. In our opinion, elimination of the completed contracts method does not have fairness as its goal and will result in long-term contractors paying more than their fair share of taxes. Certainly, this is no time to make it unnecessarily more difficult for these contractors and, consequently, their customers, to fund the capital expansion our nation sorely needs.

Please oppose elimination of the completed contracts method.

Very truly yours,

DAVID MEDENDORP,
Vice President Administration.
JON TAYLOR,
Controller and Corporate Secretary.

PRICE WATERHOUSE,
Newport Beach, Calif., March 25, 1982.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, House of Representatives, Washington, D.C.

DEAR MR. ROSTENKOWSKI: Enclosed is a memorandum prepared by our firm regarding the proposed elimination of the completed contract method of accounting for tax purposes and regulatory modifications for all long-term contracts.

The completed contract method of accounting has operated effectively from the standpoint of both taxpayers and the government for over sixty years. It is well understood and used extensively by small businesses.

The proposals appear to be an over-reaction to perceived abuses by some taxpayers operating under long-term contracts. The present income tax regulations are sufficient to deal with specific major abuses. Rather than adopt proposals aversely affecting all contractors, who by and large are non-abusers, corrective action should be taken against the few abusers.

The proposals would discriminate against contractors as compared to other taxpayers. They will severely impact small businesses and appear inconsistent with the stated objectives of this Administration.

We urge that the completed contract method of accounting not be repealed. We also believe that the major modifications of the long-term contract regulations should not be implemented.

We appreciate the opportunity to present our views on this important tax policy issue.

Yours very truly,

GAYFORD L. HINTON,
Tax Partner, Government and Other Long-Term Contractors Industry Services Group.

COMMENTS ON THE PROPOSED LEGISLATIVE ELIMINATION OF THE COMPLETED CONTRACT METHOD OF ACCOUNTING AND REGULATORY MODIFICATIONS REGARDING ACCOUNTING FOR LONG-TERM CONTRACTS

The proposal announced in the President's State of the Union Message on January 26, 1982 and the general and technical explanations of tax revisions released by the Department of the Treasury on February 26, 1982 as they related to the elimination of the completed contract method of accounting and the significant regulatory modifications regarding accounting for long-term contracts in general are of deep concern to Price Waterhouse.

The general comments represent our views as to the probable adverse effect of these proposals on a major segment of the economy, particularly smaller businesses, and the conflict they present in achieving the stated objective of this administration to ease the regulatory burden on business. The specific comments deal with the technical aspects of these proposals.

Price Waterhouse is an international firm of independent accountants with offices throughout the United States and eighty-eight foreign countries. We serve both large and small business clients who are required to operate all or a portion of their business under long-term contracts. Some, but not all, currently use the completed contract method and have done so for many years. Our comments are not on their behalf, however, but rather the views of the firm itself based on this background knowledge.

We oppose the elimination of the completed contract method of accounting and the proposed major modifications of accounting for long-term contracts. We support in concept the proposed clarifications of the regulations. We assume that specific proposals will be developed with consultation by industry representatives.

It appears to us that these proposals are an over-reaction to perceived abuses by some taxpayers operating under long-term contracts. While there undoubtedly are abuses by some taxpayers of these methods (and other methods), we believe the present income tax regulations are sufficient to deal with specific major abuses. Rather than adopt proposals adversely affecting all contractors, who by and large are non-abusers, corrective action should be taken against the few abusers.

GENERAL COMMENTS

The general explanation of these proposals estimates "that 50 percent of the output affected by the proposals is produced in defense industries, 35 percent in the construction industry, and that most of the remaining 15 percent is produced by the

heavy equipment industry." The explanation further states that "costs in the affected industries will be increased by both the regulatory changes and the legislation, since both changes will reduce opportunities for deferring tax payments on the income from long-term contracts."

What is not mentioned is that taxpayers in these groups number in the hundreds of thousands, the greatest proportion of which consist of smaller businesses. These industries in the aggregate account for a significant portion of total employment in the U.S. Although widely dispersed throughout the country, these industries constitute a significant portion of the U.S. economy.

At the present time, these very companies are suffering among the worst as a result of increased costs and inflationary pressures. Furthermore, the Administration is relying on these same companies to bolster our defense needs and contribute to the economic recovery of the country. It appears to us that quite the reverse is likely to happen. The result of these proposals will place "contractors" at a disadvantage compared to other taxpayers. If costs do increase for these taxpayers, there will be added pressure to raise prices. To the extent process are not or cannot be raised, less taxable income and decreased tax collections will result.

For the smaller businesses, who have difficulties obtaining financing and who are unable to absorb these cost increases, a greater number of business failures are likely to occur. These failures adversely affect employment, since small businesses as a group represent the largest employer in the U.S.

SUMMARY OF MAJOR PROPOSALS

The legislative proposal would repeal the completed contract method and require that taxpayers elect to use either the percentage of completion method or a new "progress payments" method of accounting for long-term contracts (as defined by the Secretary) effective for taxable years beginning after December 31, 1982.

It is not clear whether the present definition of long-term contracts would be changed.

The regulatory proposal would reduce the items of cost which are treated as currently deductible period costs. An expanded list of costs would be allocated to individual contracts.

This treatment would be required for all long-term contracts, even if the taxpayer had not availed itself of the completed contract or percentage of completion methods under existing regulations. Thus, taxpayers using an accrual method of accounting, and otherwise required to use an inventory method, would be required to account differently for costs attributable to their long-term contracts, even where such contracts may account for only a portion of their business. This provision appears to affect only contracts covered by the transitional rules (discussed subsequently), as all other long-term contracts would be required to use one of the two prescribed methods.

Contractors presently entitled to use the cash method of accounting would appear to be covered by these proposals.

The regulatory proposals also would provide two clarifications of the existing long-term contract regulations, involving severing and aggregating long-term contracts and the "completion date" of a contract, and would amend the accrual rules for multi-unit contracts.

Various "transitional" rules would be provided for contracts entered into before the date of "release." It is not clear whether the "release" date has already occurred, or if it will be the same date for the legislative and regulatory proposals.

Taxpayers required to change their method of accounting pursuant to the regulatory proposal could elect one of three transitional rules, i.e., the traditional Section 481 IRC approach (with the taxpayer retaining any pre-1954 advantage), a spread over the lesser of ten years or the number of years the former method had been used (with acceleration provisions), or the "cut-off" method. Taxpayers required to change their method of accounting pursuant to the legislative proposal would be required to use the cut-off method.

Use of the cut-off method would subject the excess of costs expensed under current rules which would be required to be capitalized under the proposals as an item of tax preference subject to the minimum tax. This appears to be a temporary measure affecting only contracts prior to the date of release.

SPECIFIC COMMENTS

Completed contract versus percentage of completion method

The explanatory comments state that "The completed contract method permits income to be deferred for tax purposes long after payments are received and long

after income is deemed earned according to standard accounting practices. They further state that "Because the percentage of completion method recognizes that income is earned over the course of a long-term contract and because it provides for a better matching of income and expense, it yields a better measure of income than does the completed contract method."

In the interest of balancing the discussion of the relative merits of the completed contract method versus the percentage of completion method, it should be noted that not all contracts are profitable; many in fact incur losses and some of the losses are substantial.

If a loss contract is reported under the completed contract method of accounting, the loss is not deducted for tax purposes until the contract is finally completed and accepted. Under the percentage of completion method of accounting, a percentage of the loss would be deductible currently to the extent costs incurred exceed the percentage of revenue recognized. Thus, since all contracts are not profitable (as premised), the completed contract method is not a panacea under which a taxpayer always wins.

The percentage of completion method is stated to be preferable because it provides a better matching of income and expense and thus yields a better measure of income.

We submit that the completed contract method of accounting provides the most precise matching of income and expense and the most exact determination of profit or loss from a particular contract. Its simplicity is one of the primary reasons it is used by many smaller contractors. These smaller companies generally do not employ the necessary personnel required to make the estimates required under the percentage of completion method.

Because the percentage of completion method does rely on estimates, it of necessity results in a less precise determination of income or loss for any single year during the life of the contract and prior to its completion. Revenue is recognized as a percentage of the total contract price (including retentions) represented by the percentage of work completed in any particular year. Costs are then deducted in the year incurred.

Under this method, the percentage of completion is determined on one of two proper bases, i.e., (1) the amount of actual costs incurred during the year in relation to total estimated costs to be incurred over the life of the contract, or (2) on the basis of certificates of architects or engineers.

Length of deferral

The explanatory comments further criticize the completed contract method because it permits income to be deferred for tax purposes long after payments are received and long after income is deemed earned according to standard accounting practices. To dramatize the period of deferral, the comments state that in certain reorder or change order agreements which taxpayers treat as part of the original contract, the period of deferral can be as long 10, 15, or even 20 years.

Prior to changes of the present long-term contract regulations in 1976, eligible contracts were limited to building, installation, or construction contracts covering a period in excess of one year from the date of executiion of the contract to the date on which the contract was finally completed and accepted. The 1976 amendments made eligible contracts which were not completed within the taxable year in which they were entered into.

These amendments extended long-term contract treatment to manufacturing contracts for the first time, but only for contracts to manufacture (a) "unique" items of a type not normally carried in finished goods inventory, or (b) items which normally require more than 12 calendar months to complete (regardless of the duration of the actual contract).

We submit that a large proportion of contracts, described as resulting in long deferrals, are in fact those not completed within the taxable year, but which would not otherwise meet the 12-month requirement of the prior regulations. Thus, we believe the reference to long periods of deferrals, when in fact many deferrals may be to only the next taxable year, overstates the reason necessitating a change.

Use of standard accounting practices

It appears that the Treasury equates the receipt of progress payments with the "earning of income or profits" from a contract. This reasoning is used to stress the shortcomings of the completed contract method and to lay the foundation for the proposed progress payment method (discussed in detail later).

The Treasury also appears to be advocating the use of standard accounting practices as a better measure of reporting taxable income. We assume that "standard accounting practices" refer to "generally accepted accounting principles."

We believed the 1979 Supreme Court decision in Thor Power Tool Company best reponds to this position. In that case, the Court reviewed the different purposes or goals of financial accounting and tax accounting and rejected the former as a proper determinant of taxable income. In light of this conclusion, we find it difficult to accept this argument as a proper basis for making changes in the tax treatment of long-term contracts. It also is interesting to note that the taxing authorities rarely suggest the use of generally accepted accounting principles in the determination of taxable income, except when these principles support their position.

Progress payment method

The only other proposed elective alternative to the accounting for long-term contracts would be the progress payment method. Under this method, a taxpayer must take all payments from each contract into income when the right to such amount accrues. All costs (with the exception of certain designated period costs) are allocated to each contract and deducted only when the taxpayer has a right to receive payment under that contract and, then, only to the extent of such payment. Losses will be recognized only if costs incurred during a taxable year exceed the total amount the taxpayer has a right to receive under the contract.

In describing the progress payment method, the explanatory comments state that: "It ensures that taxpayers who receive or have the right to receive a cash profit will include that profit in income; thus, it eliminates the most serious accounting distortions arising from the use of the completed contract method. However, when payments do not exceed costs, income earned on a contract is deferred until the contract is complete." The comments conclude: "As a practical matter, most taxpayers will choose to account for long-term contracts on the progress payment method."

The proposed progress payment method of accounting appears even more disposed to the view that the receipt of cash (or the right to receive cash) on a contract is the equivalent of income or profits from that contract. This view again assumes that all contracts are profitable. As mentioned previously, this is not the case.

The progress payment method does not result in a "clear reflection of income," although this appears to be the stated objective of the proposal. In fact, the progress payment method merely trades one perceived serious accounting distortion for another real distortion. It also produces inequitable results and could produce serious hardships.

As a general rule, a contractor must expend large sums in advance of his contractual right to collect from this customer. In fact, this is the normal pattern for entitlement to progress payments. Thus, progress payments are used as financing tools, to provide needed working capital without incurring the normal interest charges for such funds. Ultimate profit from a contract (assuming a profitable contract), which may be relatively small in relation to the total contract amount, is frequently withheld as retainages pending completion of the contract. As we understand the progress payment proposal, such retainages will not be required to be recognized as progress payments until such time as they become billable. Thus, profits (if any) may still be deferred until the contract has been completed.

To impose a tax for any year in which cash received on a contract exceeds cumulative costs to date (whether or not the contract may be ultimately profitable), but to allow the deduction of costs only when cumulative expenses exceed the total contract price, represents a classic case of "Heads, I Win; Tails, You Lose." Even a cash method taxpayer presently is permitted to deduct costs in the year paid. This now would be denied to a cash method contractor.

Depending upon the length of a contract and time frame when progress payments are received, the following hardship could result. The taxpayer enters into a five-year contract and receives progress payments in excess of cost in year 1. Costs exceed remaining progress payments during each of years 2, 3, and 4. In year 5, cost exceed total contract revenue (a loss contract), and the loss is deducted. Under the normal three-year carryback for net operating losses, the taxpayer would be unable to recover the tax paid in year 1 on "phantom income."

Given the potential for adverse tax consequences, it is doubtful that most taxpayers are likely to adopt the progress payments method, as has been assumed. Even if most taxpayers were to adopt such method, it is doubtful that significant advance tax payments would result. More than likely, taxpayers would change their contractual arrangements for progress payments and would otherwise accelerate or defer incurred costs to avoid paying tax on "excess payments."

If as further noted that profits may still be deferred until contracts are completed because of retainages, it is difficult to understand how the progress payment method will cure the perceived abuses of the completed contract method.

Change in definition of period costs

The proposed reduction in the items currently deductible as period costs, and the requirement that others be deferred by allocating these costs to contracts in progress, will discriminate against taxpayers who sell or are required to sell pursuant to long-term contracts.

At present, taxpayers using an inventory method of accounting are permitted to deduct certain costs as period costs, rather than capitalizing such amounts as inventory costs. The expense rules differ somewhat depending upon whether a taxpayer is using a comparable method of accounting for inventory for tax and financial reporting purposes or a noncomparable method. Taxpayers using non-comparable inventory methods typically would be the smaller companies who are not required to issue financial statements and who maintain their books for operational purposes.

The present long-term contract regulations also permit certain costs to be deducted as period costs rather than capitalizing such amounts as contract costs.

Attached Exhibit I compares the costs currently deductible under the inventory rules and those deductible under the present and proposed long-term contract rules. It should be noted that costs proposed to be allocated to long-term contracts are essentially the same as those which will remain deductible under the inventory rules. Thus, contractors clearly would be placed at a disadvantage.

Those expenses being proposed to be capitalized which appear to be particularly punitive to contractors compared to all other taxpayers are: 1. Research and experimental expenses. 2. Depreciation reported for income tax purposes in excess of financial statement depreciation. 3. Interest. 4. General and administrative expenses attributable to taxpayer's activities as a whole. 5. Salaries paid to officers attributable to taxpayer's activities as a whole.

All taxpayers may presently elect to expense research and experimental expenditures. This election was deemed necessary to encourage such expenditures. In the current environment, where increased emphasis is placed on U.S. business to regain our leadership in the research area, the Economic Recovery Tax Act of 1981 (ERTA) provided a tax credit for increasing these expenditures.

Under these circumstances, it is difficult to differentiate research and experimental expenditures made by a contractor, which might be directly attributable to a particular long-term contract in existence at the time such expenses are incurred or which are incurred under any agreement to perform such research, from any other research performed by any other taxpayer. To deny contractors a current deduction for these expenses not only discriminates against contractors, but makes no economic sense. Such research is just as valuable when performed pursuant to a long-term contract as similar expenditures to develop a new product which may be sold pursuant to a "purchase order."

ERTA also provided all taxpayers with an accelerated capital cost recovery system to encourage capital investment and the modernization of our production facilities. Most businesses have reacted positively to this incentive. To require contractors to forego these benefits by requiring capitalization and deferral of these accelerated capital cost allowances again makes no economic sense. Contractors invest huge sums for assets required to perform their contracts. This measure will discourage such investments for a significant group of taxpayers.

Taxpayers who are able to borrow are struggling under the burden of current high interest rates. These costs are particularly critical for the generally under-capitalized small business. Most of these taxpayers will be solaced somewhat by a current tax deduction for the interest incurred to finance their operations. Contractors will not. By requiring interest costs to be allocated to contracts in progress, contractors will be denied the current deduction for interest which is available to all other taxpayers.

Finally, all businesses are permitted current deductions for their general and administrative costs and general officer compensation. Such costs are uniformly viewed as period costs. To require contractors to allocate a portion of these general costs to individual contracts when all other taxpayers are currently deducting them is clearly punitive.

In addition to these inequities, the additional acounting required to segregate these previously deductible items and to allocate them to individual contracts will fall particularly heavy on the small business and its limited staff.

As a final observation, it is quite likely that the proposal to require capitalization of period costs may not produce the positive effect on tax revenues anticipated. Given the ingenuity of taxpayers, it is probable that contract terms will be revised to shift a large portion of these costs to purchasers under these contracts. For example, equipment used on contracts might be required to be furnished by the customer making the interest to purchase and excess depreciation deductible by him.

Clarifying proposals

The proposal to clarify when a contract should be considered complete and when contracts should be severed or aggregated are to be commended. These areas would have benefited from such guidance in the past.

In the interest of arriving at equitable and workable solutions to these questions, however, we believe that established procedures for amending regulations should be followed. The issues involve "real life" situations and the views of industry representatives working with contracts on a daily basis are essential to their resolution. For example, the comments seem to make no distinction between "change orders" and "reorders." Depending upon the facts, it is submitted that such a distinction might well determine whether a contract should be considered completed.

While we view the proposal to amend the accrual accounting method regulations with respect to multi-unit contracts as a form of clarification, we doubt that this change will produce significantly different amounts of taxable income. Our experience indicates that most taxpayers on the accrual method are already reporting sales on the basis proposed.

With respect to the proposed transitional rules, we do not believe they should be required because we see no need for adoption of the basic proposals. We note, however, the inconsistency in choices provided taxpayers between changes in method of accounting provided by the regulatory and legislative proposals. There is no choice in the case of the legislative proposal; the cut-off method must be used.

It also seems punitive to provide apparent relief under the cut-off method, but to subject that relief to a minimum tax.

Summary

In summary, we believe that the completed contract method of accounting for long-term contracts should not be repealed either by legislation or regulation.

The completed contract method has operated effectively from the standpoint of both taxpayers and the government for over sixty years. It is well understood and used extensively by small businesses. The arguments being advanced for its repeal at this time are essentially a rehash of those advanced in 1971 when a similar position was proposed. After many comments by interested and knowledgeable people at that time, the appropriateness of the completed contract method of accounting was thoroughly explored and the method was retained. In fact, the regulations previously in effect were liberalized as a result of those studies. Many of the items presently being criticized were adopted in the 1976 amendments.

The progress payment method of accounting for long-term contracts does not clearly reflect income. It is not an equitable or an acceptable method of accounting and will not change the perceived distortions of the completed contract method.

The reduction of the items considered deductible period costs and the required allocation of other period costs to individual long-term contracts (even for taxpayers using the accrual method) discriminates against contractors. Other taxpayers are entitled to currently deduct all such costs.

The clarifying amendments to the regulations are to be commended, provided that they are exposed for comment prior to adoption.

EXHIBIT I—COMPARISON OF TAX TREATMENT OF PERIOD COSTS UNDER INVENTORY METHODS VERSUS LONG-TERM CONTRACT METHODS

	Not required to be capitalized			
	Inventory methods,		Long-term contracts	
	Comparable	Noncomparable	Present	Proposed
Marketing expenses	×	×	×	×
Advertising expenses	×	×	×	×
Selling expenses	×	×	×	×
Other distribution costs	×	×	×	(1)
Bidding expenses	×	×	×	(2)
Research and experimental expenses including engineering and product development	×	×	×	.....
Interest	×	×	×	.....
Losses under sec. 165	×	×	×	×
Percentage depletion in excess of cost depletion	×	×	×	.....

EXHIBIT I—COMPARISON OF TAX TREATMENT OF PERIOD COSTS UNDER INVENTORY METHODS VERSUS LONG-TERM CONTRACT METHODS—Continued

	Not required to be capitalized			
	Inventory methods,		Long-term contracts	
	Comparable	Noncomparable	Present	Proposed
Depreciation reported for federal income tax purposes in excess of depreciation reported by taxpayer in financial statements	×	×	×	.....
Depreciation on idle equipment	×	×	×	×
Income taxes attributable to income from sale of inventories (or long-term contracts)	×	×	×	×
Pension contributions—past service	×	×	×	×
Pension contributions representing current service costs	(3)	×	×	.....
Profit sharing contributions	(3)	×	×	.....
Other employee benefit costs	(3)	×	×	.....
Costs attributable to strikes	(3)	×	×	×
Costs attributable rework labor, scrap and spoilage	(3)	×	×	(4)
General and administrative expenses attributable to taxpayer's activities as a whole	×	×	×	.....
Salaries paid to officers attributable to taxpayer's activities as a whole	×	×	×	.....

[1] Although this is normally considered a selling expense; proposal is silent.
[2] Although bidding expenses generally are not required in other than a contract situation, it should be viewed as a marketing or selling expense and is so grouped under present regulations. Successful bid no different from successful sale of inventory.
[3] Required to be treated same as financial statements.
[4] These costs have traditionally been grouped with costs attributable to strikes.

STATEMENT OF FLOYD L. RAMP, RICHFIELD, OHIO

This proposal is based upon the following assumptions:

(1) There is an urgent need to move toward a balanced federal budget.

(2) In general, taxes paid to support the federal budget should be proportional to services rendered.

(3) Expenditure for military defense is the largest item which is not supported by tax related to benefits.

(4) The value of national defense for an individual is directly proportional to the value of that protected i.e. net worth plus an allowance for protection of life and liberty.

(5) The value of liberty may equal but cannot exceed the value of life itself. Therefore, the appropriate value for protection of life and liberty is the indemnity paid to those who give their lives in service of the country.

The proposal is that Congress enact a tax on net worth and the indemnity which is designed to provide the support for the military establishment. This is, I believe, a case of simply asking payment for services rendered.

I would suggest the following items be incorporated in such a law:

(1) that the value of any asset be the price at which the taxpayer is willing to sell.

(2) that the tax be on individuals only.

(3) that all citizens be encouraged to provide for their later years and capital for the present by allowing a deduction from net worth.

(4) that this deduction should increase with the age of the taxpayer.

STATEMENT OF JAMES R. STITES, SENIOR VICE PRESIDENT, REPUBLIC GEOTHERMAL, INC.

My name is James R. Stites and I am Senior Vice President of Republic Geothermal, Inc., a company engaged in the exploration, development, production and marketing of geothermal resources. I appreciate this opportunity to supply, for the Committee's hearing record, a statement by Republic Geothermal expressing its views on the Administration's tax proposals. In particular, Republic would like to comment on the proposal of the Administration to repeal tne energy investment tax credits.

First, I would like to thank this Committee for its role in enacting the energy investment tax credits and its support of the alternative energy industry. Without question, the energy tax credits are the major factor in the remarkable progress achieved in the renewable resources sector in general, and in the geothermal area

in particular. Repeal of the geothermal tax credits will cripple or cause the demise of the geothermal industry.

We find the Administration's reasoning for the repeal of the energy tax credits to be faulty and misfounded. Other tax incentives, enacted as part of the ERTA of 1981, although greatly improving the business atmosphere, do not go far enough in attracting capital to our industries. Nor can we understand the revenue estimates we have seen with regard to collections which would occur if the energy investment tax credits were repealed. Recent studies have shown that the cost of the energy investment tax credits to the Treasury is offset by energy savings. And, under some very reasonable scenarios, Treasury will actually profit on the energy tax credit program by increased corporate revenues. Moreover, substantial federal royalties for geothermal resource production, stimulated by the energy tax credits, will accrue to the Treasury for geothermal energy development on the numerous federal leases.

If anything, we would argue that the energy investment tax credits should be increased to encourage this source of alternative, non-oil and gas production. While the fossil fuel market may now be soft, we at Republic do not feel that this country should lull itself into a false sense of security, even for the short term. If projects are now abandoned, it will take over a decade to start them up again and the U.S. will suffer the consequences. For a very minimal outlay we can continue to guard against events which are, to a large extent, beyond the control of our country.

The commercial development of geothermal resources is capital intensive, characterized by high-up front capital costs, offset by low running costs over a long operating period. A typical geothermal project will take four to five years to complete after the geothermal resources which constitute a commercial prospect have been identified. Accordingly, you will easily understand why the geothermal industry needs the maximum tax credit to attract investors to a technology which is relatively new and thus perceived, by some investors, as risky, and which takes a considerable period of time to develop. For the same reasons, the present 1985 expiration date for the geothermal tax credit is too short and should be extended. And, of great importance, at this time, is the necessity for so-called "affirmative commitments" language similar to that contained in Congressman Heftel's bill, H.R. 2640. That bill quite appropriately extends the affirmative commitments time-table through 1994 for certain non-renewable energy property. Few people recognize that there is no existing affirmative commitments section for renewable energy property, including geothermal property. Yet, in light of the constant attacks on the energy investment tax credits, and in view of the heavy capital commitments required, it is essential that, for these long lead time projects, we have the security of knowing that these projects, once undertaken, will be completed within the economic framework upon which we embarked.

We would also like to comment briefly on the controversial, so-called "safe harbor" leasing provisions. We understand problems associated with safe-harbor leasing techniques and likewise recoil at the excesses reported. But the concept of transferability of tax incidents is absolutely valid in particular situations, and the neophyte alternative energy industry presents perhaps the most meaningful of these situations: difficulty in attracting capital, inability to make use of investment tax credits until profitable, and commitment to efforts which are, without question, in the national interest. Here, if anywhere, new industries should be able to transfer their tax credits to successful industries who can thus help underwrite new, emerging alternative energy sources.

Finally, we would like to share with you the difficulties, in practice, of utilizing the energy tax credits which you have fashioned. The Internal Revenue Service has taken an unduly stringent and restrictive interpretation of the energy tax credits. For example,we were stunned to learn that equipment used to drill for and product geothermal energy was excluded from eligibility for the geothermal tax credit by IRS regulations issued in January, 1981, well after the enactment of the 1981 credits. Such equipment is fundamental to the production of geothermal energy and, we believe, was clearly intended to be eligible for the geothermal tax credit. This is merely one example of the type of obstruction posed by the Internal Revenue Service in its interpretation of the credits.

As an example of the broader questions on effective application of the tax credits, we would urge you to look at how we can best market our technology overseas which would help lessen other countries' dependence on imported oil and make our citizens the beneficiaries of lower prices based on mass production and marketing. In this regard, we invite your attention to the restriction against any property used predominantly outside the United States from qualifying for the investment tax credit. Thus, although a contractor may export important technology and "know-how", in the implementation phase, he is discouraged from taking the tools of his

trade abroad. This works against our twin goals of stimulating the economy and rectifying our now chronic negative balance of payments. Particularly in the emerging geothermal energy area, expanding the markets to include such property would dramatically reduce overall costs and further implement our national energy policy.

In closing, let me again thank you for your leadership and support in the alternative energy area. We believe that the energy tax credits have made the difference and that they have been instrumental in nurturing our fledgling geothermal industry. We implore you to stand with us once again to insure that these energy investment tax credits remain intact and, indeed, are improved and made more viable. We look forward to working with you in the future.

SHIPBUILDERS COUNCIL OF AMERICA,
Washington, D.C., April 12, 1982.

Hon. DANIEL ROSTENKOWSKI,
Chairman, Committee on Ways and Means, House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: The Shipbuilders Council of America, an industry association composed of major shipbuilders, shiprepairers and ship component manufacturers in all sections of the country, is gravely concerned with respect to the Administration's proposal to eliminate the completed contract method of tax accounting.

Under the completed contract method of tax accounting (CCM), the profit or loss from a long term contract is reported in the tax year in which the contract is completed. In shipbuilding, completion of a single ship within a year from the date of contract signing would be a rare exception. Furthermore, most shipbuilding contracts are changed during the period of construction to add, delete or modify features of the ship at the discretion of the owner, or, in the case of naval ships, at the discretion of the U.S. Government. Because even the simplest of ships is exceedingly complex, a change in the design of one area after the start of the construction cycle frequently delays or disrupts the work in constructing other parts of the vessel. Thus, it is virtually impossible to determine the true cost of construction, and hence profit or loss, until the vessel is completed and delivered.

The completed contract method of tax accounting has been authorized for shipbuilders since 1918. It was the subject of an extensive five-year study by the Department of the Treasury ending in 1976, which concluded that CCM was a reasonable and equitable way to handle the profit or loss on extended and unpredictable contracts. It conforms with taxation principles applied to other taxpayers. Any unwarranted change, such as in this instance, in the taxation of government contractors would be inappropriate, especially at a time when the U.S. Navy is in critical need of expansion.

The U.S. shipbuilding industry has suffered a tremendous reduction in the volume of merchant ship construction, principally as a consequence of the world shipping depression and excessive subsidies granted shipyards in other countries on naval shipbuilding. The Navy program is now expanding and hopefully stability will eventually be restored in commercial ship construction.

Elimination of the completed contract method must therefore be viewed not only in the context of current conditions but also in terms of future potentials.

The economic effect on naval shipbuilding would be twofold. First, because of cash flow problems for the shipbuilder which would be incident to CCM elimination, it is clear that the Navy will be paying higher prices on future shipbuilding contracts and Federal budgets for these purposes will be even more constrained. Second, it is also clear that much of the funding now made available through CCM and presently devoted to capital improvements and to improving manufacturing technology would no longer be available. Thus, the rate at which naval shipbuilding technology is improved would be slowed considerably.

Commercial shipbuilding would be affected even more severely. The industry's ability to compete for commercial shipbuilding contracts has been increasingly impeded by foreign governments' subsidization of materiel, labor and financing for shipbuilding in their nation's shipyards. These incentives for shipbuilding are renewed and strengthened every year by many of those foreign governments. Below-cost "political pricing" is commonplace. In contrast, the United States is moving in the opposite direction. Traditional forms of maritime subsidies are targeted for reduction, if not outright elimination. Clearly, if CCM is eliminated, prices in this country will also increase and the U.S. shipbuilding industry will be further restrained in endeavoring to compete for commercial shipbuilding in the world market.

We most respectfully suggest that you consider the impact that the elimination of CCM will have on an industry in crisis before you vote on the Administration's proposal. A more detailed discussion of our position is enclosed for your perusal.

We stand ready to work with you in developing reasonable alternatives.

Sincerely,

EDWIN M. HOOD, *President.*

COMMENTS ON THE PROPOSED ADMINISTRATIVE ALTERATION AND LEGISLATIVE REPEAL OF THE COMPLETED CONTRACT METHOD OF ACCOUNTING

GENERAL EXPLANATION AND SUMMARY

Under the completed contract method of accounting,[1] profit or loss from a contract involving a long-term building, installation, construction or manufacturing project is reported for federal income tax purposes in the year in which the project is completed. The completed contract method is an application of general rules of taxation to the specific case of long-term contracts and was first authorized by Treasury regulation in 1918. It has remained essentially unchanged over the years and is a widely practiced method of tax accounting today.

During the five-year period 1971 through 1976, a detailed examination of the completed contract regulations was undertaken by the Treasury. After substantial comment from and discussion with the affected public, the Treasury confirmed the validity and utility of the method. In fact, with the promulgation of the final revised regulations in 1976, the application of the completed contract method was expanded to specifically include long-term manufacturing activities (as to which there had been some doubt about eligibility. The revised regulations were also intended to resolve several ambiguities in the prior regulations and case law and to provide support for the more effective audit of taxpayers using the method by the Internal Revenue Service. Specifically, the 1976 amendments:

Defined when contracts were complete—and specifically stated that "a taxpayer may not delay the completion of a contract for the principal purpose of deferring federal income tax;"

Limited the conditions under which a taxpayer could add to an existing contract, and thus prevent its completion, and at the same time authorized the Internal Revenue Service to sever a contract into two or more separate contracts if necessary to clearly reflect income;

Set forth detailed provisions governing the effect of disputes between the parties on the questions of completion and income measurement;

Set forth detailed provisions, modeled closely upon the inventory costing regulations, governing the allocation of cost to contracts in progress on the one hand or to a contractor's business generally on the other. In the former instance, the costs are deferred until contract completion; in the latter instance, the costs are currently deductible as so-called "period costs."

Today, barely six years after the detailed review and re-affirmation of the completed contract method regulations, the Administration proposes a complete reversal of this well established and widely utilized tax method by (i) eliminating the completed contract method entirely by legislation substituting a newly invented "progress payment method" and (ii) pending such elimination, drastically altering the treatment of period costs by amending the completed contract regulations.

The Administration's proposal is ill-conceived. It departs from tax accounting principles applicable to taxpayers generally and represents an arbitrary and discriminatory application of the tax laws to one portion of American industry—that portion which happens to engage in building, installation, construction or manufacturing projects which extend beyond a single tax year.

The Shipbuilders Council of America, representing 21 shipyards involved in more than 90 percent of ocean-going ship construction in the United States, respectfully submits that Congress should re-affirm the validity of the completed contract method and prohibit any changes in the Treasury regulations which discriminate against long-term contractors. The current completed contract regulations are more than adequate to permit the Internal Revenue Service to stem any "abuses" of the completed contract method and eliminate any "unintended tax benefits" which may be perceived by the Treasury.

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[1] Treas. Reg. § 1.451-3(d).

The completed contract method is a proper method for the ship construction industry

The current consistent treatment of all contractors.—The validity of the completed contract method and its consistency with methods of tax accounting utilized in a typical manufacturing business is demonstrated by a comparison of the tax treatment of both entities. In the instance of a typical manufacturer making a product for sale to customers in the ordinary course, the accounting flows are relatively simple to follow. As manufacture progresses, the costs of material and labor and other, indirect, costs properly associated with the product are accumulated and constitute the accounting value assigned to the work in progress. Upon completion, the sum total of such costs constitutes the accounting value assigned to the manufactured item as it is placed in product inventory. Upon sale, this accounting value is taken out of inventory and becomes the cost of the good sold. If the amount received from the customer exceeds the cost, there is a profit on the sale; if the amount received is less than the cost, there is a loss.

In concept, the accounting flows associated with the completed contract method of accounting are no more complicated than those associated with the instance just described. To take the simplest case, assume the construction, not of a series of relatively small items to be placed in inventory and then sold to customers, but rather of one large item—a ship—which takes several years to complete and is constructed pursuant to a contract with the purchaser. The fact that the item is expensive, the construction period long and the customer identified prior to commencement of construction does not distinguish the accounting flows associated with the ship from the accounting flows involved in the more typical manufacturing business. Thus, as construction progresses, material, labor and overhead costs properly associated with the product would be accumulated and placed in a work-in-progress account. Upon completion, the sum of those associated costs would be transferred to a finished goods account and, upon sale, amounts received for the item compared to the cost thereof and profit or loss determined. (If the product is sold upon completion, the interim step of placing the product in a finished goods account is unnecessary.)

The method of accounting just described with respect to the long-term construction project, which is virtually identical to the method of accounting described with respect to the more typical manufacturing business, is the completed contract method of accounting described with respect to the more typical manufacturing business, is the completed contract method of accounting—all costs properly attributable to the product are accumulated until sale, at which time profit or loss is determined. Given this identity, any attempt to deprive the group of businesses that engages in projects with building, installation, construction or manufacturing periods which exceed beyond a single tax year of the ability to determine profit and loss upon sale would improperly discriminate against that group. This is the fundamental problem with the Administration's attempt to terminate the completed contract method of accounting.

Progress payments as a financing technique.—Nonetheless, the Administration suggests distinctions between long-term contractors and short-term contractors which, it suggests, justifies disparate tax treatment.[2] Foremost is the general practice of the receipt of funds by long-term contractors from purchasers (in the form of progress payments) prior to completion and sale. In fact, it is suggested that, but for the presence of progress payments—perceived as a pool of funds out of which tax revenues could be derived—the Administration would not have targeted long-term contractors for accelerated taxation.

It is thus essential to recognize that the receipt of funds by long-term contractors by means of progress payments constitutes a source of financing for such contractors and, in this light, is indistinguishable from the receipt of loans by long-term contractors—or short-term contractors—from third party sources such as banks, funds which would be clearly non-taxable. Long-term construction of major projects lends itself to financing through progress payments. Short-term construction—for inventory—lends itself to third-party (generally, bank) financing. The source of funds does not change the economics of the transaction or the timing of completion and sale—the taxable event. Thus, the source of funds is an inappropriate basis for discriminating between taxpayers.

Treasury recognition of advance funding as non-taxable.—The Treasury itself has implicitly recognized the economic identity of financing through customers and financing through third party sources. After extensive consideration in the early 1970's, detailed regulations dealing with "advance payments" from purchasers were

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[2] General and Technical Explanations of Tax Revisions and Improved Collection and Enforcement Proposals, Department of the Treasury, February 26, 1982, Completed Contract Method of Accounting, (hereinafter referred to as General and Technical Explanations), P. 2.

promulgated permitting the deferral of the inclusion of such payments in gross income. (Treas. Reg. § 1.451-5.) In general, under such regulations an accrual basis taxpayer (other than certain taxpayers having a defined amount of inventory on hand) may defer the inclusion of advance payments in gross income until the year in which such payments are accruable under the taxpayer's method of accounting for tax purposes, provided that the deferral is to a point no later than the time such advance payments are included in gross receipts for purposes of financial reports to shareholders, creditors, etc. The regulations go on to provide an exception to the financial statement conformity requirement, however, for contractors accounting for advance payments under long-term contracts pursuant to the completed contract method or pursuant to accrual methods of accounting under which income is accrued when, and costs are accumulated until, the subject matter of the contract is shipped, delivered or accepted. In such instances advance payments are included in income in the taxable year in which properly included in gross receipts pursuant to such method of accounting, regardless of financial statement presentation. (Treas. Reg. § 1.451-5(b)(3))

In other words, subject only to a conformity requirement of limited applicability, the Treasury has determined that advance payments received with respect to construction-type contracts—whether or not involving more than a single tax year—need not be included in income.[3] This policy is the correct policy; distinctions should not be based upon sources of financing and taxation should not be accelerated to a point prior to completion and sale—contrary to the universal rule—based upon such distinctions.

If financing by means of progress payments were to be eliminated as a result of the taxation of all or part of such payments—as the Administration is suggesting—the long-term contractor might, of necessity, turn to complicated and cumbersome agency or service arrangements in an attempt to avoid any new Internal Revenue Code provision. More likely, the long-term contractor would turn to third party financing and pass the cost along to the purchaser. The result would be economically inefficient as the increased level of contractor debt could often raise the overall interest cost to such contractor above the level of the cost of money provided by a purchaser financing but one project. This inefficiency would be especially obvious—and costly—in the instance of ship construction for the Defense Department in that the cost of funds to the United States is substantially below the cost of funds for the shipbuilder.

The supposed problems of the completed contract method

The Administration claims that the completed contract method has led to so-called "unintended tax benefits" for, or "abuses" by, long-term contractors. The Shipbuilders Council maintains that the "unintended benefits" are not unintended and that the "abuses" are not abuses. Rather, the workings of the completed contract method and the tax results arising therefrom are wholly consistent with the workings of the accounting methods applicable to the more typical manufacturer and with the tax results thereof.

The issue of taxation after receipt of funds.—For example, the General and Technical Explanations, page 2, states that "[t] he completed contract method permits income to be deferred for tax purposes long after payments are received . . . " and describes this as an "unintended benefit." However, it is not true that the receipt of progress payments during the construction period results in an "unintended tax benefit." In the first instance, the practice has been going on for more than sixty years and, thus, could hardly be said to have been "unintended." Moreover, as has just been pointed out, receipt of funds from a purchaser prior to completion and sale is really a form of financing and should not result in taxation, a result which has been confirmed by the Treasury in the advance payment regulations.

The issue of conformity with financial accounting.—The General and Technical Explanations also asserts, at page 2, that the completed contract method "permits income to be deferred for tax purposes . . . long after [it] is deemed earned according to standard accounting practices." This assertion fails to recognize the distinction between financial accounting and tax accounting. It is true that for financial accounting purposes, the percentage of completion method of accounting—whereby projected income from a long-term project is recognized as construction progresses

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[3] Even in the context of those taxpayers receiving "substantial" advance payments which have inventories of the goods involved on hand, such payments may be deferred for as long as two years following the year of receipt. (Treas. Reg. § 1.451-5(c)) Interestingly, with finished goods and cash on hand, taxation prior to sale would appear justified; nonetheless, deferral is permitted by the Treasury.

by use of ratios involving either physical completion or cost comparisons—is generally "preferred" to the completed contract method by the Financial Accounting Standards Board ("FASB") (See Statement of Financial Accounting Standards No. 56, February 1982) and is utilized by some completed contract method taxpayers for financial statement purposes. However, the percentage of completion method was also considered "preferable" to the completed contract method by the Committee on Accounting Procedure of the American Institute of Certified Public Accountants-a predecessor to FASB—in Accounting Research Bulletin No. 45, issued in October, 1955. Nonetheless, the 1955 "preference" did not affect the use of the completed contract method for tax purposes in the 1950's and 1960's—nor in the early 1970's when the Treasury specifically considered requiring conformity of method for book and tax purposes. After due consideration, the Treasury abandoned the conformity notion.

Similarly, the FASB designated "preference" should not influence consideration of the merits of the completed contract method for tax purposes in 1982. Income based upon the percentage of completion method is obviously income based upon estimates—of physical completion, of costs to come, of revenues to come and, most importantly, of ultimate profit and loss. The use of estimates is generally to be avoided for the purpose of exacting taxation. Estimated figures, although satisfactory for purposes of allocating some measure of income among accounting periods for financial statement purposes, are unsatisfactory as the basis for taxation, both because of the uncertainty of the estimating process and because of the substantial possibility that events will occur subsequent to the estimate to materially alter the accuracy of any interim income figure. Thus, Treasury Reg. § 1.451-1(a), in setting forth the general rule for the taxable year of accrual of amounts in income, states that "income includible in gross income when all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy."

In fact, given its reliance upon estimates with concomitant controversy and given the special risks inherent in most long-term contracting, the percentage of completion method has generally been considered unacceptable by taxpayers even though the method allows the recognition of losses for tax purposes prior to completion.

The issue of open contracts.—Another "abuse" referred to in the General and Technical Explanations, pages 2 and 7, comes about because certain taxpayers defer income recognition by maintaining that contracts ae not complete because of provisions for engineering or assembly services to take place after delivery of parts and materials or because of the addition of an additional number of items to be supplied under the original contract.

This "abuse" does not indicate a flaw in the completed contract method and surely does not require the completed contract method as a whole to be eliminated. Rather, the solution to the failure of some taxpayers to close contracts and recognize income when it becomes fixed and determinable is contained in the existing regulations which give the Internal Revenue Service the power to divide what is purportedly one contract into several contracts for purposes of income recognition.[4] Surely the Internal Revenue Service could take the position in a published revenue ruling or upon audit that, in proper circumstances, "engineering or assembly services" do not constitute "building, installation, construction or manufacturing" and therefore may be severed under the existing regulations. If the facts support this position, the Internal Revenue Service will be sustained; if such services do qualify as an integral part of the four eligible activities, the Internal Revenue Service would not, and should not, be sustained.

Similarly, the Internal Revenue Service could take the position under the existing regulation that if an existing contract—for example, a contract calling for construction of X airplanes at an overall price of Y dollars, is amended to add additional airplanes at Z dollars each, such amendment constitutes a severable contract and the original contract must be closed upon delivery of the X airplanes. Historically, the Internal Revenue Service has accomplished much more with much less in the way of regulation support; the absence of diligence on the part of the Internal Revenue Service in implementing the current completed contract regulations should not be the basis for unwarranted legislative, or even regulatory, activity.

The issue of period costs.—A final area of "unintended tax benefit" referred to in the General and Technical Explanations, pages 2 and 6, involves the current deduction of indirect costs incurred by a contractor prior to completion of a contract, with

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[4] Treas. Reg. § 1.451-3(e)(1) provides that "for the purpose of clearly reflecting income, it may be necessary in some instances . . . to treat one agreement as several contracts . . . whether an agreement should be so severed/. . . will depend on all the facts and circumstances."

the result that the overall taxable income of the contractor is reduced during the construction period. Although the matter of the deduction of so-called "period costs" is treated in detail below, it should be emphasized here that the need to determine what costs are attributable to work in process and what costs are attributable to contractor's business generally is, once again, not a deficiency in the completed contract method and does not result in any "unintended tax benefit." The method requires—as do the regulations promulgated in 1976—that costs properly attributable to construction should be deferred and that only costs not attributable to construction may be deducted currently. Here, too, the rule is precisely that applicable to other manufacturers (See Treas. Reg. § 1.471-11 "Inventories of Manufacturers") and here, too, the solution is proper enforcement, not abolition or amendment.

The completed contract method is particularly appropriate for ship construction, which is subject to major risks and uncertainties throughout the construction period

Fundamental fairness requires that taxpayers with long-term construction projects not be denied the application of the basic profit-on-sale tax rule applied to other taxpayers. In fact, application of the profit-on-sale rule is especially compelling in the case of major construction projects. Most, if not all, such long-term projects are subject to substantial risks and uncertainties during construction which prevent the interim computation of gain or loss.

Certain of these risks and uncertainties were set forth by the Internal Revenue Service in a 1970 revenue ruling (Rev. Rul 70-67, 1970-1 C.B. 117). The ruling referred to (1) changes in the prices of articles to be used, (2) losses and increased costs due to strikes, (3) losses and increased costs due to weather conditions, (4) penalties for delay, (5) other unexpected difficulties. It was these possibilities which, the ruling concluded, "make it impossible for any construction contractor, no matter how carefully he may estimate, to tell with any certainty whether he has derived a gain or sustained a loss until a particular contract is completed."

Risks and uncertainties, both as to costs and as to prices, exist to a major degree in the shipbuilding industry, generally, and especially with respect to building highly sophisticated ships for the United States Navy. In addition to the normal risks inherent in a construction project which could (in the instance of an aircraft carrier) take up to ten years, it is common for the Navy to request changes—often more than 2000—during construction of a warship, many of which must be implemented before the final price for the change is agreed upon. Typically, the contractor also makes a large number of changes in its initial detailed specifications and drawings to ensure mating equipment and system compatibility and to meet overall ship specification requirements. Then, too, the construction of a ship involves constant "work-arounds" (that is, scheduling and construction changes), both because it is not economically feasible to schedule and control the ship manufacturing process in exact detail and because technological or design advances require flexibility, if not outright alteration.

Thus, not until a ship has been completed and tested can the shipbuilder be relatively assured of what its actual costs will be. Even at this point the re-work of items which do not meet specifications must be completed before final costs can be determined.

On the pricing side, too, there is much uncertainty, both because, as described, substantial work is undertaken pursuant to change orders prior to the determination of the amount to be paid for the change and because current shipbuilding contracts involve complicated cost sharing provisions, cost incentive provisions, performance incentives and discretionary fee awards. These types of provisions prevent the accurate determination of the "plus" in so-called "cost-plus" contracts and, in fact, can result in substantial losses with respect to such contracts by requiring sharing of cost overruns, placing maximums on cost recoveries or designating certain type of costs as nonreimbursable. Moreover, and importantly, the Defense Department retains the right througout each contract to terminate the contract in whole or in part for any reason, an event which can drastically alter the contractor's profit picture at any time.

It is no answer to state that profit estimated on an interim basis can always be subsequently adjusted downward, or even be offset by a greater, subsequent, loss in the event these types of risks become realities. A taxpayer should not be required to pay taxes on amounts which are not fixed and determinable profits; the fact is that an interim "profit" is not a profit at all, given the obligation to continue to completion and the potential costs associated with completion. Risks and uncertainties turn into realities throughout the construction period (for example, change orders, unallowable costs, the potential exercise of discretion in fee awards, the possibility

of failing to meet specifications, future warranty expense, etc.). Pricing such events prior to completion is extremely difficult, and would often involve pure guesses, surely leading to controversy and litigation with the Internal Revenue Service.

The administration's proposed "progress payment method" is ill-conceived and inequitable

The Administratioin proposes to sweep away the completed contract method—and its sixty-four year history—and substitute the newly invented "progress payment method." Under the progress payment method, a taxpayer must take progress payments into income at the time the right to payment accrues but may deduct the total of the current and previously unclaimed costs allocated to the contract up to the amount of the accrued payment. For this purpose "certain borrowings" in lieu of payment will be treated as payment. If the accrued payments exceed costs, the taxpayer would recognize the excess as income. However, if costs exceed accrued payments, the taxpayer would not be permitted to recognize a loss.

It should be clear that the progress payment method is not a method of determining income at all. Rather the progress payment method essentially taxes net cash flows. Cash or accrued receipts to date are compared to certain categories of costs to date; if there is an excess, taxes are owing. Thus, if a purchaser advances substantial funds at the outset of the contract (but not enough to constitute "a significant percentage of the total contract price," allowing some kind of a spread over a "longer" period according to the General and Technical Explanations, page 9), the contractor will be taxed—even if it is virtually certain that the contract is unprofitable. Moreover, if the contractor borrows funds from its bank—secured by the contract—the borrowings will be income, a concept that goes well beyond any authority.[5] This aspect of the proposal can only lead to the creation of indirect borrowing techniques, disparate treatment of economically similar transactions and controversy.

On the other hand, if the contractor's front end costs are substantial but its cash receipts are minimal or nonexistent, no interim loss recognition is permitted—the Administration's proposal is a "Heads, I win—tails, you lose" proposition.

In sum, the progress payment method is inequitable, it is discriminatory, it is contrary to tax accounting principles, and it is unnecessary. To the extent that the so-called "abuses" of the completed contract method are abuses, they can be eliminated by effective administration of the completed contract regulations. Surely that possibility must be explored before throwing the baby out with the bath water.

The administration's proposal to require taxpayers using the completed contract method to defer costs which are currently deductible by other taxpayers is unwarranted and improper

The Current Consistent Treatment of All Taxpayers.—all methods of tax accounting classify production costs into two categories: (i) costs which relate to items produced, for which any tax deduction is deferred until the items are completed and sold, which are referred to as "project costs," and (ii) costs which relate to the taxpayer's business as a whole, which generally are deductible on a current basis in the period in which they are incurred and which are accordingly referred to as "period costs". The completed contract method is no exception. The distinction between these two categories of costs has been a part of the completed contract method since the method itself was first approved by regulation in 1918.

For many years, however, the completed contract regulations gave little guidance as to which costs were related to, and thus properly allocable to, a long-term project and which related to a taxpayer's business as a whole. Rather, taxpayers relied on interpretive rulings, case law, specific statutory provisions and, to a great extent, general business and accounting practices.

The current completed contract regulations, promulgated in 1976, contain detailed rules for the clarification of costs. They were designed to restate the costing rules found in case and ruling authority and to be conceptually consistent with, and similar to, the inventory costing regulations applicable to short-term manufacturers—promulgated as part of the same Treasury regulation project—and with the tax costing rules applicable to taxpayers generally.[6] It was the Treasury's belief at the time

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[5] But, interestingly, is a recognition that progress payments are equivalent to third-party financing. The Administration concludes that the equivalence results in taxation for both forms, rather than to no taxation for both. Consistency with the treatment of other taxpayers and sound tax policy would favor the latter view.

[6] For example, it is generally understood that a significant consideration in the ultimate classification of pension and profit sharing and similar employee benefit costs under both the cur-

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that if economically equivalent activities were not treated similarly for tax purposes, taxpayers would rearrange their transactions to obtain the more favorable tax treatment and those taxpayers who were unable to do so would be put at an unfair disadvantage. This proposition is as sound today as it was six years ago.

Nonetheless, the Administration proposes to create a new cost accounting system applicable only to long-term contractors. Under the proposed system long-term contractors would be required to defer the deduction of most costs which are otherwise universally deductible on a current basis. Such discriminatory treatment is totally unjustified and would no doubt lead to the significant economic distortions the Treasury was seeking to avoid in its comprehensive treatment of period costs in the regulations projects of the 1970's.

For example, the future owner-user of a contemplated project may have the option of either contracting with another business (a long-term contractor) to construct a project or constructing the project for its own account. In the case of contracting out, the proposed costing rules would apply—deductions for most of the contractor's expenses (for example, general and administrative, selling, interest, accelerated depreciation) would be deferred—the cost of construction would escalate. In the case of self-construction, most, if not all, of these (and other) expenses would be deductible currently and the net cost of construction would be less. Thus, singling out the long-term contract arrangement for special tax treatment could force the owner-user into the self-construction format, even though self-construction may not, for a variety of business reasons, be the appropriate route. Moreover, given two competitors one of which, for business reasons, cannot self-construct, the bias against contracting out could place that party at an unwarranted competitive disadvantage.

The Treasury itself has acknowledged the substantial economic dislocations that can be expected if there is disparate tax treatment for the costs of third-party contractors and self-contractors. It has used this economic dislocation rationale to support its proposal to require capitalization of self-construction costs in a limited area—construction period interest and taxes in the case of certain real estate. As is stated in the General and Techanical Explanations, at page 37:

"[I]f a corporation contracts with another firm, a corporation, or unincorporated entity, under the proposed contract accounting rules, he will incur a capitalized building cost that includes the full pre-tax amount of interest and property taxes incurred in its construction. But, if the purchaser corporation would not be required to capitalize these same costs if they are incurred on its own account, the corporation will have an incentive to legally arrange its relations with the contractor so as to bring the construction activity into its own accounts and continue to benefit from current deduction of construction period interest and taxes."

Under the Administration's proposal, the very same problems of inconsistent tax treatment with which the Treasury is concerned in the real estate area would occur in the case of non-real estate projects, such as shipbuilding, and would occur with respect to the wide range of recognized period costs other than interest and taxes. Thus, the Treasury apparently is cognizant of the problem that its long-term contract proposal creates but offers no solution beyond its narrow proposal to deal with real estate construction. If the basic tax accounting principles are changed for long-term contractors, they would also have to be changed for self-constructors, manufacturers, merchants and all other taxpayers. Otherwise, the economic disruption which the Treasury fears will result.

The classification of costs under current regulations is sensible and proper.—The current completed contract regulations divide the expenses of operation into three categories: (i) costs which are directly related to long-term projects, such as direct labor and materials, (ii) indirect costs which are incident to and necessary for the performance of particular long-term projects and thus which are properly allocable to such projects (for example, maintenance and repair expenses relating to equipment used in the performance of particular projects), and (iii) costs which are not required to be included in costs attributable to long-term projects. The regulations require that the first two categories of costs be allocated to specific projects, to be deducted only when the gross income from that project in included in income, i.e. in the year the project is completed. The third category of costs, which includes marketing and selling expenses, general and administrative expenses, interest, accelerated depreciation, research and development expenses, and certain fringe benefit

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rent completed contract regulations and the inventory regulations was the long standing position of the Internal Revenue Service concerning the current deductibility of such costs in the area of self-constructed property. *See* I.T. 3408, 1940-2 C.B. 178. *Compare,* also, Treas. Reg. § 1.471-11(c)(2) and (c)(3) *with* Treas. Reg. § 1.451-3(d)(5).

costs, including group insurance and workmen's compensation expenses and pension and profit-sharing contributions, are treated as period costs.

The list of costs which may be treated as period costs under the current regulations is varied. However, the treatment of each such cost as a period cost may be justified on one or more well reasoned grounds. For example, many of the costs which are treated as period costs under the regulations are clearly not incident to and necessary for particular projects and thus are per se not properly related to production. Such costs presented no classification problem even under the less detailed standards of the prior regulations. They would include losses, income taxes, and marketing and selling expenses.

Costs may also be properly included in the period cost category because they are not subject to allocation by project on any sound conceptual basis—they are considered to more properly relate to a taxpayer's activities as a whole even though they are, arguably, marginally related to production. Such costs would include interest, research and development expenses and general and administrative expenses. Any allocation of such costs would necessarily be arbitrary and imprecise and would be likely to result in controversy.

Consider, for example, the impossibility of allocating interest on general corporate borrowing to particular projects, or, due to the significant "make-up" element which may be included even in the current funding portion of pension plan costs, the difficulties in relating such costs to a specific period, let alone specific contracts worked on during that period. The current regulations, the product of an intensive undertaking by the Treasury designed to bring greater certainty in this area of tax accounting, recognize that such arbitrary and imprecise determinations should be avoided.

The current regulations also recognize that Congress has established a policy of encouraging certain types of activities through the tax system by deliberately providing for current deductibility. For example, Section 174 of the Internal Revenue Code provides for the current deductibility of certain research and development expenses as an incentive to engage in such activities. The incentive would be lost if these costs were somehow apportioned to long-term projects and the deduction deferred. Accelerated depreciation is another example of the same type of item. The investment incentive which comes through the use of accelerated methods of depreciation would be eliminated if the deduction were deferred pursuant to regulation. Similarly, Congress has provided a current deduction for contributions to qualified retirement plans to encourage employers to establish such plans for their employees, even though the recognition of compensation income by the covered employees is deferred.[7] Consistent with these Congressional goals and with the treatment afforded other taxpayers, the current completed contract regulations recognize all three of these costs as period costs.

Finally, costs are also properly included in the period cost category because their current deductibility is established by long standing case and ruling authority, regardless of the degree to which they are thought to be "allocable" to a specific project. An example is the treatment of various employee benefit costs, such as group insurance premiums, which under the prior regulations were generally considered to be subject to the same rules as apply in the related area of self-constructed assets and which for the same reasons are treated as period costs under the current regulations. *Compare* I.T. 3409, *supra*, with Treas. Reg. § 1.451-3(d)(5)(iii) and § 1.471-11(c)(2)(iii)(c).

In summary, the detailed rules in the current regulations reflect over sixty years of evolution of the principles of cost allocation in respect of long-term contracts and are designed to make sure that taxpayers using the completed contract method are treated consistently with other taxpayers. The Administration is now proposing to create a system of costing unique to taxpayers using the completed contract method under which the current deductibility of most period costs would be denied. The purported justification for this dramatic change in existing law is the old sop, "to achieve better matching." However, the Administration's proposal suffers from tunnel vision in that it ignores the patent inconsistency with its own tax incentive programs. Of equal importance, the proposal ignores the long history of the completed contract method and the careful considerations of the early 1970's which went

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[7] It is also important to note that the statutory provisions governing the maintenance of qualified retirement plans require regular contributions and limit the amount of contributions which may be deducted in any one year with respect to such plans. Any attempt to defer the deduction of such costs by means of regulation would run directly counter to these provisions and could jeopardize the deductibility of such costs by taxpayers using the completed contract method because of the operation of these annual deduction limits.

into the development of the current regulations. Thus, the proposal serves only to unnecessarily and unjustifiably discriminate against long-term contractors and to engraft new uncertainties, complexities and inequities onto a system which has operated smoothly and with limited controversy for years.

Summary and recommendation

The Shipbuilders Council respectfully submits that the Administration's legislative and regulatory proposals are both ill-conceived and unwarranted. They treat similar taxpayers in dissimilar fashion and thus contribute to economic dislocation. They ignore the more than sixty-year history of the completed contract method, including the detailed review and affirmation of the method by the Treasury in the early 1970's. They fail to recognize that the current regulations provide the means to deal effectively with taxpayers misapplying the method to their unintended benefit.

Congress should not eliminate the completed contract method of accounting. Congress should direct the Treasury to make no changes in its regulations with respect to the method which will discriminate against long-term contractors.

SISTERS OF MERCY HEALTH CORP.,
Farmington Hills, Mich., March 17, 1982.

Hon. DANIEL ROSTENKOWSKI,
Washington, D.C.

DEAR REPRESENTATIVE ROSTENKOWSKI: Attached is a letter sent to Senator Robert Dole, Chairman of the Senate Finance Committee, regarding the Committee's recent deliberations over the Administration's attempt to add restrictions onto the tax exemption of bonds for tax exempt organizations.

The Sisters of Mercy Health Corporation is a not-for-profit multi-hospital organization and owns and operates Our Lady of Mercy Hospital in Dyer, Indiana—astride the border of the Indiana and Illinois state line. About 25 percent of the patients we serve reside in Illinois.

Our constituency is concerned that by restricting the tax exemption of bonds for tax exempt organizations, you would severely exacerbate the financial strain already felt by non-profit hospitals, impair our ability to renovate and modernize existing facilities, and prevent expansion in those areas where patient needs warrant construction of additional facilities.

Please examine the attached position paper on capital financing for voluntary hospitals. We believe you will agree with us that the proposed new restrictions on the use of tax exempt bonds by private not-for-profit hospitals will not be in the best interest of the people in your district.

Respectfully yours,

EDWARD J. CONNORS, *President.*

[The attachment referred to is identical to a letter at p. 560, sent to the chairman from Edward J. Connors, chairman, Associated Hospital Systems.]

STATEMENT OF DAN THROOP SMITH, SENIOR RESEARCH FELLOW, HOOVER INSTITUTION, STANFORD UNIVERSITY

The Congress must now choose how best to balance three desirable objectives, each of which is important by itself, when they temporarily conflict with each other.

Reduction in the growth of government expenditures and reduction in the growth of taxation are each desirable goals—President Reagan gave the lead in 1981. The Congess sensed the widespread support throughout the country for both objectives. Legislation in 1981 moved effectively along both lines.

But there was and is a third goal—reduction of the deficit to provide a more solid base for control of inflation. The present problem—almost a crisis in confidence—arises from the soaring deficit, which is widely perceived to be inflationary. In economic affairs, expectations are likely to be self-fulfilling. A failure to deal with the deficit directly and promptly will strengthen the fears and uncertainties in the minds of individuals and business. Fears and uncertainties, in turn, in the present circumstances will lead to continuing recession.

Furthermore, and most seriously, the large deficit throws an intolerable burden on the Federal Reserve system. Reduction in the excessive long-run and rather erratic growth in the money supply and adoption of a steadier and lower rate of growth in it are essential to control inflation. In spite of disagreements about the best way to measure changes in the money supply, and to appraise the significance

of divergent movements among them, the Federal Reserve has followed a sound policy—a policy essential to wind down inflation. And now it is the Federal Reserve which bears the brunt of the criticism for the parlous side of the economy and the human distress which has developed, temporarily, from the recession.

The deficit is now the major unsettling factor. There are many ways of measuring the deficit—as a proportion of the gross national product, in relation to current savings, or in relation to some concept of "slack" in the economy. Each of the measures may have some real as well as theoretical significance. But it is the way the deficit is perceived which influences confidence and action—and inaction.

The economy is not a mechanistic system, in which people, as individuals and business managers, act as they may be presumed to act in some theoretical model. People act in response to what they perceive to be the situation and the prospects for the future. It is the conventional budget which determines perceptions. And the deficit thus measured indicates a budget out of control and hence inflationary—with a greater burden thrown on the Federal Reserve to resist pressures to monetize the deficit.

The deficit, through the pressure it exerts on the Federal Reserve and the financial markets, is largely responsible for the persistence of high interest rates which prolong and accentuate the recession. There is no ideal or certain remedy. What is the least bad action to take?

Further reductions in the general level of Federal expenditures are desirable—both to reduce the general burden and because many programs have at last been recognized as counterproductive even by their original protagonists. We each have our favorite areas which we regard as inadequately funded now. My own major concerns for the environment and programs for rational family planning may not now be in fashion politically and will have to be curtailed, temporarily. Further reductions in total expenditures should be made.

But prospective reductions do not appear to be adequate to restore confidence in non-inflationary government finance. We are thus left with tax policy. For those of us who have hoped and worked for tax reduction, it is distasteful to propose new taxes or a postponement of any scheduled tax reductions, but it now seems necessary to do so.

A fundamental point to remember is that some taxes are much more repressive than others. A bad tax system can be destructive even though the total tax burden is modest. With a relatively high total tax burden—which we seem doomed to continue to have even under the most optimistic assumptions—the structure of the tax system is critically important. And in this respect, the tax reductions of 1981 were, in general, wisely designed to reduce the worst features of our existing tax system.

High marginal income tax rates are the most perverse of all taxes. The removal of the discrimination against investment income by bringing the tax rate down to the 50 percent level, already established for earned income, was a major improvement. This automatically brought the maximum rate on capital gains down from 28 to 20 percent. This reduction in the highest marginal rate is the most likely of all tax revisions to be self-financing in the sense that it may be expected to lead to an offsetting increase in revenue.

The scheduled further reduction in marginal income tax rates is the most effective form of additional individual income tax reduction. But the effectiveness of reductions decreases at lower levels. A reduction from 70 to 50 percent can be expected to have a major impact on attitudes and investment whereas a commensurate reduction from 14 to 10 percent at the bottom of the progressive scale is unlikely to have much effect on attitudes, especially when the modest increases in takehome pay are submerged by changes in pay scales and consumer prices.

Indexing of individual income tax rates and brackets was long overdue. It is essential to prevent unlegislated increases in tax burdens under any degree of continuing inflation. Its adoption in 1981 was a truly major reform. It must not be revoked.

Some form of faster capital recovery was also appropriate. The phase-in of full expensing, combined with a reduction of the corporate tax rate, provided in an alternate tax reduction might have been preferable. Though the statutory rates established in 1981 will prevent controversy on periods for capital recovery, they still invite controversy as to whether specific items should be allowed for immediate espensing or thrown into a short period of capital recovery.

But the capital recovery provision permitting sale and lease-back of depreciable property to transfer tax credits and deductions to another company had little, if any, justification except, perhaps, for small new companies. The sales and lease-backs between large companies both of which are awash with cash has no justification and should be prevented promptly, not only to curtail further loss of revenue

but to reassure the public that the new legislation was not the result of successful lobbying for special business interests.

The full intended benefit of the tax reduction through faster capital recovery is thwarted by a procedure required by the Financial Accounting Standards Board. The income taxes shown on financial statements must be those which would have been paid if depreciation for tax purposes had been the same as that shown on a company's books rather than the change for capital recovery allowed by Congress and actually taken. The effect of this is to overstate taxes actually paid and understate actual income. The difference between taxes actually paid and the taxes that would have been paid in the absence of tax relief is shown as "deferred taxes," a wholly misleading designation for a continuing company with fairly steady retirements and replacements, even under a stable price level. For growing companies, or continuing companies under inflation, the so-called deferred tax account which properly constitutes a part of retained earning will grow and, for capital-intensive industries, reach very large amounts.

The all-savers certificates represented the success of a very successful lobby effort. Ostensibly designed to help the savings and loan banks, they were extended to cover all banks, as might have been expected. It is now generally recognized that the all-savers certificates involve overwhelmingly a shuffling of funds from one account to another, as was predicted by dispassionate critics when the legislation was first proposed. The revenue loss, though still undetermined, was very large; the increase in total savings and deposits in savings and loan associations relatively small. It should be made clear that no extension will be authorized beyond this year.

I shall comment only briefly on the two major tax relief measures so important to married couples. The removal of gift and estate taxes for transfers of property between spouses by gift and at death recognizes for tax purposes the real community of interest which is presumed to exist in marriage. Socially, the reform was long overdue, Economically, it reduces the tax which more than any other tax absorbs capital. Heirs and donees cannot be expected to save more to restore a pre-tax capital sum. The revenue secured come almost wholly from the nation's financial capital. Relief was thus consistent with tax revision designed to build up the country's net savings and investment.

The marriage tax which amounts to several thousand dollars a year for couples each member of which has substantial income is unconscionable and further jeopardizes the too-fragile institution of marriage which is still deemed socially desirable. But the form of relief chosen applies only to earned income. Thus the legislation which removed the general discrimination against investment income at the top tax rate has created a new discrimination against couples each of whom has investment income. The only fair—and moral—action would be to apply the relief to both forms of income, and phase it in as revenue needs permit.

The foregoing comments indicate that the principal provisions of the 1981 tax legislation are consistent with the desired—and desirable—objective of reducing the most burdensom tax barriers to saving and productive activity and investment. The most important changes became effective on January 1 of this year. They should not be reversed, except with respect to the trafficking in tax credits and deductions through the sale and lease back of tax credits and deductions. (The present practice is reminiscent of the "trafficking in losses" which was becoming scandalous in the 1950's until prevented by legislation proposed under the Eisenhower Administration.)

Some other changes in the income tax law under discussion may appropriately be made not only for the revenue involved, which in some instances may be minor, but also to maintain general respect for the integrity of the tax system. In addition to the familiar items widely discussed, I urge attention to abuses under foreign trust and charitable organizations.

The reduction in the capital gains rate insofar as it applies to reinvested capital gains was eminently desirable. A tax on reinvested capital gains is a tax on financial capital and depletes financial capital commensurately. But there is little, if any, justification for the lower rate of tax on non-reinvested capital gains, especially when they arise from short-term speculations rather than long-term investments. Tax-free reinvestment of capital gains should be permitted, with non-reinvested gains taxed in full, but legislation for this could not be developed quickly. In the meantime, the holding period for favorable tax treatment should under no circumstances be shortened.

For substantial revenue—and as a symbol of concern for the deficit—I particularly urge increases in existing excise taxes. The fact that our liquor, tobacco and gasoline taxes are based on quantity rather than price—a fact which many knowledgeable people seem not to recognize—has meant that under inflation these taxes have

benefitted from unlegislated tax decreases. It is a perverse contradiction that while income taxes, the most repressive of all taxes, have been subject to unlegislated tax increases under inflation, the excise taxes, the least repressive taxes, have received unlegislated and largely unrecognized tax decreases. Now is the time to make good some of the past short-fall and base the future excise taxes on price rather than quantity.

The gasoline tax is properly regarded as a user charge and should be raised not only to prevent future unlegislated tax decreases but to finance prompt maintenance of the nation's highways. Proposals for new and increased user charges for the air transportation system and such other government services which may be covered by user charges would be timely.

It is, of course, undesirable to raise any taxes during a recession. But it is also undesirable to let deficits increase during an inflation. At present, the damage from increasing deficits outweighs the damage from increasing taxes. Increases in excise taxes would be the least objectionable form of tax increases—and some tax increases are necessary if only to show an adequate concern for the deficit.

Finally, the question arises as to whether the last stages of the individual income tax reduction might be postponed. Decision on this subject is the most difficult of all. Deductions in marginal income tax rates, for reasons already given, will help revitalize the economy. Prospective reductions should not be revoked. But the third and final stage, scheduled for 1983, might be made conditional on the budget, and more importantly, on the situation regarding inflation. On balance and with some regret, I conclude that the damage from making the final stage of the individual income tax rate reduction conditional would be less than the damage from continued high deficits. Useful though they would be in reducing tax barriers to savings and investment, the next stages of rate reduction should not be counted on to be so powerful as to produce off-setting increases in revenue.

The most important tax revisions are in place. The less important one, under the force of circumstances, should be made conditional on changes in circumstances.

Statement of Suzette Tapper, Solar Lobby

SUMMARY

The Solar Lobby is a membership organization representing 45,000 members.

We support the business energy tax credits.

We reject the Administration's policy of relying solely upon price to determine the choice of energy resources.

That policy ignores: our need for jobs—the quality of our environment; our vulnerability to energy cut-off; the need to keep capital in this country, and our national security.

The free market does not in fact exist because all energy is subsidized by government in one way or another.

The business energy tax credits, far from being a drain on the Treasury, actually results in a net gain to the Treasury by decreasing fossil fuel expensing.

This Administration has created an unstable business climate by alternatively promising these tax credits would remain in effect while advocating their repeal. If our economy is to improve it must be a high priority to create a favorable investment climate.

A current report by the Midwest Governor's conference demonstrates that economic growth can come to a halt if sufficient revenue is leaving a region to pay for energy costs.

It is simply unacceptable for this country to continue to be vulnerable to yet another oil cut-off.

Mr. Chairman, members of the Committee, ladies and gentlemen, I am Suzette Tapper, legislative and tax specialist for the Solar Lobby. I am pleased to have the opportunity to appear before this Committee in support of the retention of the business energy tax credits.

The Solar Lobby is a membership organization based in Washington, D.C., representing over 45,000 small businessmen and solar enthusiasts throughout the United States who believe that an expeditious transition to the use of renewable energy resources combined with aggressive programs fostering energy efficiency is the only basis of a sound energy policy that can enhance security of the United States in the next decade.

Our membership supports the business energy tax credits for renewable energy, not just because the credits are a significant factor in the continued investment and

expansion of a domestic renewable energy industry, but because renewable energy is the safest, cheapest, and most plentiful source of energy. Several national polls have shown that the majority of the American public prefers the development of renewable energy options above any other energy option.

The Treasury Department reported on February 26, 1982 that the credits should be revoked because they are "inconsistent with the Administration's philosphy of relying on markets to allocate resources efficiently and with its policy to rely on the market, rather than Federal management to determine patterns of energy use."

This assumes that whatever is cheapest to the consumer today will be the nation's best energy choice. We think there are additional considerations and refect this naive anf irresponsible basis for public policy which ignores the following principles that we think should guide our energy choices:

Sources of energy that created jobs in the United States are more desirable than those that don't;

Sources of energy that don't pollute the environment are better than those that do;

Sources of energy that we don't have to defend militarily are better than those requiring such defense;

Sources of energy that keep money within our economy are better than those that drain money to foreign countries;

renewable energy sources are better than any other energy form that is not produced domestically; and

renewable energy businesses employ more people per dollar invested than other energy forms.

Because of the benefits to national security, employment, and public health, renewable energy is the first choice in any national energy policy. These credits are the cornerstone to ensure that the private sector is encouraged to integrate this energy source into the United States economy quickly and extensively. Because alcohol fuels, hydroelectric power, solar energy, and wind power are so important to the United States, even in this oil-glutted market, we must maintain a positive investment climate, which has faltered because of the Administration's proposed repeal of these business energy tax credits.

The Solar Lobby would like to point out that all the conventional forms of energy in use in the United States today are subsidized by the U.S. government up to 46 percent. Repeatedly, we have called on the Federal government to give renewable energy its fair share of R & D funds and tax incentives.

We also wish to point out that these tax credits add revenue to the U.S. Treasury. These business energy tax credits will provide a net gain to the Treasury because corporations (most of whom are in the 46-percent bracket) are allowed to deduct the cost of fossil fuels as a business expense, subsequently lowering their taxable income. The Treasury would be increasing revenues every time a business takes the energy tax credits because they would gain income that woud have been lost in fuel expensing. The saving to the government increases when fuel prices go up because these businesses would take even greater fuel tax expenses. A study done for DOE by Lawrence Livermore Labs took business tax expensing for fossil fuels into account when projecting the cost of solar tax credits. The study concluded that the current 25 percent composite credit would net the U.S. Treasury approximately $956 million between 1981 and 1990. The Reagan Administration, failing to take into account the revenue loss from fossil fuel expensing, wrongly projected that the repeal of the tax credits in 1983 would yield $100 million to the Treasury.

Another important case for keeping the tax credits involves the mixed signals government gives the private sector. Government cannot keep on changing rules in the middle of the game. This does irreparable harm to businesses who have invested millions of dollars on the basis of government guarantees. In addition, tax credits cause people to make investments that they otherwise would not make. The city of Oceanside, California, raised $20 million in investment capital with which to buy solar equipment to lease to their residents. There is no question that these investors would not have put up their money unless there was a 15 percent energy investment credit.

Another point for the Committee's consideration is that there are no other private tax incentives to help the renewable energy industry. ACRS did not help solar relative to other technologies. In fact, it may have put renewable energy technologies at a serious disadvantage.

Finally, we need the tax credits to help create jobs for Americans and to improve our national security. The Solar Lobby mailed to many Members of Congress a 1981 report from the Midwest Governors Conference that had some startling conclusions.

The report found that: if business as usual continues for the next five years, over $400 billion dollars will leave the region to imported energy; as a result of this major loss of revenue, economic growth could come to a halt and the most labor-intensive industries would be cut by 25 percent. A million jobs could be lost. In contrast, a domestic renewable fuels industry has enormous job-creation potential and could produce revenue for the U.S. Treasury.

Finally, there is no way this country should be at the mercy of another oil cutoff—whether caused by a cartel, political instability, or natural disaster. The United States must have a renewable resource energy base for its security. The retention of the business energy tax credits is the first step in encouraging the private sector to help us move in this important direction.

The Solar Lobby would like to thank you Mr. Chairman and members of the Committee who have advised the President that these business energy tax credits are vital and need to be kept intact.

Statement of Tax Executives Institute, Inc.

I. ACCELERATED CORPORATE INCOME TAX PAYMENTS

A. The proposal

Briefly stated, the Administration proposes to accelerate the collection of corporate income taxes by:

Increasing the amount of estimated tax payments required to avoid the penalty for underpayment from 80 percent to 90 percent of the tax shown on the return for the year.

Extending the phaseout of estimated tax payments based on the prior year's tax liability by limiting these exceptions for certain large corporations [1] whose estimated tax payments are at least 85 percent for 1985 (and 90 percent thereafter) of their tax liabilities as shown on their tax returns for those years. Under present law, for 1984 and thereafter the prior year's tax liability effectively may not be used as a basis for computing a large corporation's estimated tax payments since the general 80 percent rule will apply in any event.

Requiring that all remaining tax be paid on the return due date. Under present law the remaining tax may be paid in two equal installments, one on the initial due date and the balance ninety days thereafter.

B. TEI's comments

Corporate taxpayers have always encountered considerable difficulty in predicting financial results with precision. Today's volatile economic environment significantly exacerbates this problem. the current 80 percent rule is a reasonable and practical solution to the very real problem of predicting taxable income.

In the Treasury Department's "General and Technical Explanation of Tax Revisions and Improved Collection and Enforcement Proposals," released February 26, 1982, hereinafter referred to as Treasury Department Explanation, it is stated that corporations have the ability to estimate their income on a monthly basis and that, therefore, a 10 percent deviation is sufficient to reflect the uncertainties of intra-year estimates. This is simply not the case. Most companies do not have the ability to estimate accurately financial or taxable income on a monthly basis. Also, by statute, many items of taxable income and deductions are not fixed until the end of the taxable year, thus making it impossible to estimate these amounts during the taxable year. For large companies, particularly those with international operations, a reliable estimate of taxable income is not produced until many months after year-end. Indeed, even the current 80 percent rule, which the Treasury Department Explanation gratuitously labels a "substantial deviation," is one with which many companies have difficulty. We believe that were it not for the existence of the "prior year's tax" safe haven rule Treasury statistics would substantiate that, in fact, the existing 80 percent rule is not simple to comply with (unfortunately Congress has already rendered this safe haven rule largely ineffective).

We are of the opinion that increasing the prepayment requirement to 90 percent would place an unreasonable burden on corporate taxpayers. The 20 percent penalty for underpayment coupled with the inability to predict taxable income with 90 percent accuracy will cause corporations to either substantially overpay their taxes or pay high penalties. Such a state of affairs would not be in the interests of sound tax

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[1] Corporations with taxable income of $1 million or more in any of the three preceding years.

administration and would result in inefficient uses of capital resources and increased refund claim activity.

We believe that the existing 80 percent requirement is more than sufficient to satisfy estimated tax payment requirements. The 80 percent requirement leaves some room for inaccuracies in estimates. The current nondeductible penalty adequately discourages deliberate underpayments. Similarly, since the extension of the phaseout of the exceptions for estimated tax payment penalties based on the prior year's tax liability is one aspect of the proposed acceleration of estimated taxes from 80 to 90 percent, we believe that there is no need to revise the phaseout schedule as provided under current law.

Moreover, we believe that the two installment option for payment of the remaining tax liability properly recognizes that preparation of an accurate tax return for large corporations is often not possible to accomplish within 2½ months following the close of the tax year. The increasing complexity of corporate tax returns makes early filing extremely difficult. Most often an extension for filing until six months following the due date of the return is required. Payment of remaining tax liability in two installments allows the taxpayer reasonable time to correctly compute and pay the estimated amount due. Hence, eliminating the two installment procedure will create more inaccuracies in tax payments and would impose an unjustified economic hardship on corporations by forcing overpayments in order to avoid the imposition of penalty.

In summary, these tax payment proposals address themselves only to cash flow considerations and totally ignore the significant administrative complexities which they would cause. We respectfully urge that they be dropped from any proposed legislation.

II. ALTERNATIVE CORPORATE MINIMUM TAX

A. The proposal

In summary, Administration proposes to repeal the present 15 percent add-on minimum tax for corporations and create a 15 percent alternative minimum tax. The tax will be imposed on certain items of tax preference and applies where the alternative minimum tax exceeds the regular corporate income tax.

B. TEI's comments

We believe that it would not be in the interests of sound tax administration to impose a new "tax superstructure" upon the current tax system. It is our belief that the proposed alternative minimum tax on corporations is ill-advised and will clearly serve as a penalty on activites encouraged by past Congressional enactments.

For many corporations the proposed alternative minimum tax would necessitate the accumulation of complex data not presently gathered, resulting in additional administrative burdens and costs. Substantial additional data processing, accounting and operational efforts will be required in many companies. A new level of complexity would be added to an already overly complex tax system. Especially for those companies subject to the tax, productive human and financial resources will be depleted.

While we express no opinion on specific items of tax preference which are part of the proposal, we sincerely believe that enactment of the altenative minimum would constitute a disservice to the principles of sound administrative tax policy.

TEXAS INSTRUMENTS INC.,
Dallas, Tex., March 24, 1982.

Hon. DANIEL ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
U.S. Congress, Washington, D.C.

DEAR CHAIRMAN ROSTENKOWSKI: I am most concerned about the Administration's proposal now pending before the Ways and Means Committee which would disallow the use of the completed contract method of tax accounting effective January 1, 1983.

With the Administration and the Congress firmly committed to improving this Nation's defense posture and with their joint commitment to encouraging increased investment and capital expansion in order to buttress our economic health, I find it inconsistent that Treasury would now adopt a "quick fix" in its search for immediate revenue which would have the long-term effect of countering both of these stated initiatives. I urge that the Committee reject legislative elimination of the completed contract method.

96-396 O—82——49

For many firms performing long-term defense contracts, elimination of the method would have a major unfavorable financial impact by severely reducing cash flow. Contractors would face a further increase in borrowing costs at today's high interest rates for either operating or investment capital. As the cost of money is not allowable on government contracts, the necessity to bear the expense would lead to reduced profits which in turn would further reduce resources for investment in new plant and equipment. Ironically, it would ultimately diminish tax revenue, countering over the long term the purpose of the Treasury in seeking this action.

Last year, the Congress set the stage for economic recovery that will ultimately benefit all Americans. In the interest of continuing that essential, but politically difficult, strategy for a consistent long-term response to our economic stagnation, let me again urge that you and your colleagues avoid dismantling the completed contract method, for both policy and sound tax accounting reasons.

The enclosed memorandum responds in some detail to the statements made by Secretary Regan during his appearance before the Ways and Means Committee in defense of the Treasury's proposal. The paper addresses both the technical and policy aspects of the issue. Should you or your staff have any question concerning its content or if we can be of any further assistance regarding this matter, I encourage you to contact either our Corporate Tax Counsel, Randy Capps (214/995–4372), or Corporate Treasurer, Marvin Lane, Jr. (214/995–3213).

With best wishes, I am,

Sincerely,

MARK SHEPHERD, Jr., *Chairman.*

Completed Contract Method of Tax Accounting

This is to address President Reagan's proposed legislative and regulatory changes to the tax accounting treatment afforded long-term contracts. After a brief description of the current rules for such contracts, we shall respond to certain statements made on February 22, 1982, by the Honorable Donald T. Regan, Secretary of the Treasury, before the House Committee on Ways and Means and the Senate Finance Committee. Our responses will also be made to additional statements contained in the "General and Technical Explanations of Tax Revisions and Improved Collection and Enforcement Proposals" released by the Department of Treasury on February 26, 1982. Finally, we shall discuss the merits of the technical proposals and how they relate to Texas Instruments Incorporated ("TI").

I. CURRENT RULES

Current Treasury regulations allow taxpayers to report profit or loss fromlong-term contracts using (1) the completed contract method, (2) the percentage of completion method, or (3) any other method if the method chosen clearly reflects income. The latter alternative has generally taken the form of accrual methods under which the income is accrued when, and costs are accumulated until, the subject matter of the contract is shipped, delivered or accepted.

Under the completed contract method, income and losses derived from long-term contracts are recognized for tax purposes in the taxable year in which the contracts are completed. The method has been sanctioned by Treasury Regulations since 1918, and was used by manufacturers as early as the 1930's. The rationale behind this method was succinctly state by the IRS in 1970:

"One of the reasons why permission to report on a completed contract basis is given in the case of building, installation and construction contracts, is the fact that there are changes in the price of articles to be used, losses and increased costs due to strikes, weather, etc., penalties for delay and unexpected difficulties in laying foundations which make it impossible for any construction contractor, no matter how carefully he may estimate, to tell with any certainty whether he has derived a gain or sustained a loss until a particular contract is completed." Rev. Rul. 70–67, 1970–1 C.B. 117.

At TI we adopted the completed contract method for use in the government electronics segment of our operations. The inherent uncertainties as to price and cost in our defense contracts exist to a much greater degree than in the building and construction industry referenced by the IRS. For example, significant technological breakthroughs often occur during the development and production phases of weapons system components which necessitate substantial changes both to units already produced and to units yet to be manufactured.

Similarly, there are instances where the Government unilaterally directs major changes to be made in the contract with the price to be negotiated at a later date.

The Government also retains the unilateral right during contract performance to terminate the contract in whole or part. Such actions could significantly affect expected profits. Additionally, Government contracts utilize a variety of sophisticated provisions such as ceiling prices, incentive clauses, and the like which could result in prices, incentive clauses, and the like which could result in final profit substantially greater or less than that originally anticipated. Thus, TI's use of the completed contract method is consistent with its conceptual basis as described by the IRS.

II. SECRETARY REGAN'S STATEMENTS IN SUPPORT OF PROPOSED CHANGES

Statement No. 1

"Current regulations allow contractors to defer tax on income from long-term contracts until the year that the contract is completed. This completed contract method of tax accounting permits full deferral of income reporting on progress payments received by the contractor throughout the term of the contract even though certain costs are currently deducted."

TI response No. 1

The Secretary noticeably omits the fact that contractors must also defer any losses from long-term contracts until they are completed. Moreover, he suggests that there is a necessary and quantifiable deferral of income from the payments received during the course of a contract. Actually, due to future unanticipated costs incurred in contract performance, any profit element in such payments may be illusory and never materialize. It is because of the uncertainties as to costs, profits or losses during the life of our countracts that profit cannot be determined to the level of accuracy required for tax accounting purposes until the contracts are finally completed. At that point in time, the uncertainties have been resolved and income or loss can first be accurately determined. The currently deductible costs he references are not costs of production, but rather unrelated costs generally deductible by all taxpayers whether or not using the completed contract method, and whether or not accounting for long-term contracts.

Statement No. 2

"The completed contract method thus permits income to be deferred for tax purposes long after payments are received and long after income is deemed earned according to standard accounting practices."

TI response No. 2

The Secretary again fails to mention that production expenses and losses are also deferred. Additionally, he does not acknowledge, as the IRS did in 1970, that any income from such contracts, and the extent of such income, cannot be accurately determined until the contracts are complete.

He appears to use standard financial accounting practices as a proper measure of the income that should be reported from long-term contracts. TI uses the accrual shipment method for its financial reporting of income from such contracts. Prior to adopting the completed contract method, TI also used that method for its tax reporting, as specifically allowed by current Treasury regulations. Although acknowledging the accrual shipment method as an accurate measure of taxable income, Treasury's legislating proposal would abolish its use for long-term contracts.

The only reason tendered for the disallowance of the accrual methods for long-term contracts is found in Treasury's February Release, where problems similar to those encountered in the completed contract method are cited. The release states in part:

"Under these methods, taxpayers would defer income, but deduct certain costs currently in a manner similar to that provided by the completed contract method and, in addition, could elect the further tax deferral benefits of the Last-In, First-Out inventory accounting method. However, This could occur only when the product manufactured constituted inventory."

As noted above, TI's prior use of the accrual shipment method for tax purposes paralleled its financial accounting treatment. Our costs of contract performance, follow a "learning curve", so that as production proceeds our cost per unit decreases. Recognizing this fact, we estimated our total future costs of production under each contract and averaged this cost among the units to be manufactured. In our defense contracts each product is priced on a unit basis. Thus, as each unit was shipped, we reported the unit price in income and deducted the corresponding average unit cost. Additionally, we utilized the lower-of-cost-or-market inventory convention available to accrual basis taxpayers. The completed contract method was an attractive alternative to TI because it does not involve any estimates.

Treasury's objection to the accrual methods appears to be two-fold. First, some companies using those methods have not reported any income from long-term contracts until the final unit is shipped or accepted. This abuse will be cured by Treasury's regulatory proposal requring all taxpayers using those methods to do what TI did, namely, report income upon the shipment or acceptance of each unit during the curse of the contract. Second, some taxpayers have adopted the Last-In, First-Out (LIFO) inventory accounting method. This method would be attractive to companies experiencing rising costs due to inflation. Instead of averaging their unit costs as TI did, they deduct the current cost-per-unit form the unit price as each item is shipped or accepted. This perceived abuse is easily cured by requiring such taxpayers to average their costs.

Statement No. 3

"The use of the completed contract method has led to large and unintended tax benefits. For instance, many contractors, including virtually all in the defense and aerospace industries, can substantially reduce their tax liability through the use of the completed contract method. This is accomplished by deferring all income from a contract until the contract is completed while taking allowable deductions for indirect costs currently. In some cases the period of deferral can be as long as 10, 15 or even 20 years."

TI response No. 3

The Secretary refers to large and unintended tax benefits allowing taxpayers to substantially reduce their tax liability. Although some manufacturers had already adopted the method, regulations expressly allowing use of the completed contract method by manufacturers were first proposed in 1971. After extensive and thorough review by IRS, Treasury and the staff of the Joint Committee on Taxation, the method was deliberately extended to manufacturers in final regulations issued in 1976. It was apparently recognized that due to the uncertainties involved in many types of long-term manufacturing contracts, the completed contract method was an acceptable alternative. As a result of the in-depth review of the method prior to finalizing the regulations in 1976, the deferral characteristics of the method were known, however, it was recognized as a reasonable and equitable accounting method for companies that could not accurately determine their taxable income or loss from long-term contracts until they were complete.

Any abuse in this area would appear to come from deferrals of 10, 15 or even 20 years. The February Treasury Release indicates that these extended deferrals are resulting from certain re-order or change order agreements which taxpayers treat as part of the original contract. Treasury's regulatory proposal would stop this abuse by treating such modifications as a separate contract of as several separate contracts. In this regard, we would like to point out that over 90 percent of TI's long-term contracts are completed in 2 years. Most of the remaining contracts are closed within 4 years. It is rare for a TI contract to extend beyond 4 years. Since the abuse to which Treasury objects will be stopped by the proposed regulatory amendments, it is not fair to deny the use of this method, through the legislative proposal, to TI and other companies that are not receiving long deferrals of their tax liabilities.

Statement No. 4

"Because of inflation and the increasing size of new contracts, deductible costs on new contracts often exceed income to be recognized from old contracts in any one year. The result has been that many taxpayers, while enjoying substantial economic profits and reporting these profits to shareholders and creditors, have been reporting large losses for tax purposes. These tax losses may shelter other income from taxation. In at least one case, the losses have been sufficient to eliminate the taxpayer's accumulated earnings and profits, enabling that taxpayer to make tax-free distributions to shareholders."

TI response No. 4

While using the completed contract method of accounting, TI has reported significant income from its defense contracts every year. The currently deductible costs TI has incurred offset only a small percentage of the income recognized from old contracts. It should be noted again that these currently deductible costs are not related to the production of items under new contracts. Rather, they are unrelated costs which benefit TI's operations as a whole. Such costs include general and administrative costs, interest, research and experimental expenses, pension costs and other employee benefits. These expenses are currently deductible by all taxpayers. The Legislative and regulatory proposals would unjustifiably attempt to treat companies in-

volved in long-term contracts differently than other taxpayers, by not allowing period expensing of such costs.

The Secretary's objection to large losses taken by some taxpayers due to these currently deductible costs could be prevented through a simple amendment to the present rules: Period costs can be deducted only up to the amount of income recognized from old contracts. This prevents reporting of losses in the situations described and does not penalize companies such as TI which have not abused the current rules.

Statement No. 5

"A particular problem resulting from the long-term contract accounting rules arises because certain construction contracts and contracts for the sale of heavy equipment include provisions for engineering or other assembly services to take place after delivery of parts and materials. Many taxpayers obtain additional deferral by maintaining that contracts are not complete until such services have been rendered. This is done even when full payment has been received upon delivery of parts and materials."

TI response No. 5

TI does not treat outstanding engineering or other assembly services required under a long-term contract as a basis for determining that such contracts are incomplete. To the extent that other taxpayers have taken this position, the regulatory proposal will prevent such treatment by providing that the contracts are complete when the only remaining performance required is to provide such services.

III. MERITS OF REGULATORY PROPOSAL

Treatment of indirect costs

The regulatory proposal would require that most indirect costs could not be currently deducted for long-term contracts. This is a substantial deviation from existing regulations and the tax treatment afforded other taxpayers. The proposal would necessitate the deferral of expenses which are costs of the current period and not of the product. Such costs do not represent value added that fairly should be capitalized and deferred under the contract. We see no basis for treating companies using the completed contract or other long-term contract methods differently from other taxpayers. This appears purely to be a "revenue enhancing" measure which results in taxpayers using a long-term contract method bearing an unfair portion of the current revenue needs of the government.

Other clarifying provisions

The other proposed regulatory amendments regarding when two or more agreements shall be treated as one contract, use of the accural methods, and when a contract will be considered complete are designed to prevent abuses perceived by Treasury and are therefore not objectionable to TI, as proposed.

IV. MERITS OF LEGISLATIVE PROPOSAL

Treatment of indirect costs

The legislative proposal contains the same changes to the indirect costing rules as found in the regulatory proposal. TI objects to these changes for the reasons stated above.

Disallowance of the completed contract method

The completed contract method would be disallowed under the legislative proposal. Taxpayers would then be required to use either the percentage of completion method or a new progress payment method.

As previously discussed, the completed contract method is the best solution to the problems involved in determining costs, profits and losses from TI's defense contracts. The contingencies involved in such contracts prevent the accurate determination of profit or loss until the uncertainties are resolved upon completion of the contract. Other methods require the reporting of income based upon the circumstances then in existence. Since subsequent unanticipated events can substantially affect TI's profit or loss position on a contract, it is only fair to defer tax reporting until the contingencies have expired. The equitable results flowing from the completed contract method were apparently recognized as overshadowing the deferral characteristics resulting from its use after the extensive review conducted prior to its express extension to manufacturers in 1976.

To the extent the method is being abused by certain companies, the regulatory proposal adequately prevents this in the future. For example, the extended deferrals (up to 20 years) and aggregation of independent agreements into one contract will not be allowed prospectively. Thus, with the abuses stopped administratively there is no justification for terminating this viable tax accounting method.

Required use of percentage of completion or progress payment methods

The Percentage of Completion method is one of two alternative methods required under the legislative proposal. This method permits current deductions for allowable costs but requires reporting income according to the estimated percentage of cost completion or physical completion of contracts during the taxable year. Although a substantial amount of highly subjective judgment is required, such estimates are common for the purpose of making business decisions. In our government electronics business, however, it is not feasible to make these determinations with accuracy sufficient to satisfy tax accounting standards which require the annual reporting of income based on a reasonably high degree of certainty and objectivity. Such estimates would create an atmosphere of uncertainty and would open the door to disputes with the IRS on audit. It was precisely this type of uncertainty that the completed contract method of accounting was designed to prevent.

The progress payment method is the only other method permitted for long-term contracts under this proposal. It is a method not heretofore provided for in the regulations. The method will cause the anomalous result that any income from a contract is reported currently, while losses are deferred. Moreover, significant inequities will occur for those contracts giving rise to advance payments. Such payments will cause substantial profit to be reported in the early years of a contract which may never actually be earned. In such a situation, fictional gains will be reported during the first part of a contract and fictional losses reported in subsequent years. This distorted timing flow definitely favors the government and unjustifiably penalizes taxpayers.

Furthermore, there appears to be no basis for disallowing use of the accrual methods currently available to taxpayers if the completed contract method is terminated. With the minor changes referred to above which can be effected through regulatory amendments, these methods should continue sound for tax reporting purposes. Secretary Regan recognized this point when he used current financial reporting procedures as a proper standard against which to compare the results of the completed contract method.

V. EFFECTIVE DATES

Under the legislative proposal taxpayers will be required to use a cut-off method in making the transition from the completed contract method. Contracts entered into on or before February 26, 1982, will be "grandfathered." Therefore, companies may continue to use the current long-term accounting rules for those contracts until they are complete. This benefit is offset, however, to the extent that indirect costs are deducted under the old rules for the "grandfathered" contracts in amounts exceeding those costs deductible under the new cost rules, because an item of tax preference would be created subject to the minimum tax. Contracts entered into on or after January 1, 1983, would be accounted for under the cut-off method using the new rules. Problems can arise for those contracts entered into during the "window" period of February 27, 1982, to December 31, 1982. Such contracts would be accounted for under the old rules starting in 1983. This places an unnecessary administrative burden on taxpayers in requiring different tax accounting treatment for the same contract over a period of time. Moreover, for companies such as TI which experience significant up-front costs on contracts which decline over time on a "learning curve," excess expenses over revenue incurred during the window period will be deferred until those contracts are completed. Accordingly, we recommend that all contracts entered into before 1983 be grandfathered to prevent this inequity and the administrative burden.

Since the administrative problems will also occur for those companies electing the cut-off transition rules for any regulatory amendments made, we similarly request that pre-1983 contracts be "grandfathered" for those purposes.

VI. CONCLUSIONS

The completed contract method has been recognized as a sound tax accounting practice for over 60 years. The only justification for its disallowance is to enhance Federal revenues. The regulatory amendments proposed, however, will probably result in almost as much revenue to the Treasury. We therefore recommend that

the regulatory amendments designed to prevent the abuses in use of the method be effected and that the method continue to be available to taxpayers such as TI for whom it is the best method for determining taxable income from long-term contracts.

The Treasury has not justified the termination of the accrual methods of accounting under the legislative proposal. Furthermore, Secretary Regan expressly acknowledged these methods as a proper standard for tax reporting purposes. Therefore, in the event the completed contract method is disallowed, we think the accrual methods should continue to be available to contractors in accounting for their long-term contracts.

With respect to the proposed changes in the rules regarding the current deductibility of indirect costs, we believe the Treasury is overreaching. It is not just to require taxpayers involved in long-term contracts to defer the deduction of costs which all other taxpayers generally can deduct. The deduction of these indirect costs is not a situation where contractors are abusing the rules, but rather one in which they are availing themselves of a right all taxpayers have. This change, again, is motivated only by a desire to enhance revenue. It is inequitable, to require that long-term contractors pay a disproportionate share of the government's current financial needs. Thus, we suggest that no changes be made in the present rules for deduction of indirect costs.

Finally, in the interest of fairness and decreased administrative burden, we request that any changes made, whether through legislation or regulations, be prospective in nature commencing in 1983.

TOUCHE ROSS & Co.,
Washington, D.C., March 31, 1982.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, Longworth House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: The Ways and Means Committee is presently holding hearings with respect to various tax proposals initiated by the Treasury Department, as well as other possible proposals to be submitted by witnesses testifying at your hearings. On behalf of Touche Ross and Co., I would like to present my firm's comments on several of the Treasury Department proposals, with the request that they be placed in the record of the hearings and considered by your committee in any tax measure that may be marked up.

Touche Ross is a major international public accounting firm, with an extremely diverse tax practice. As practitioners, and tax consultants to a wide range of industries and types of business entity, and with a practice encompassing both the largest companies and the smallest businesses, we have a strong interest in both the policy and technical ramifications of major tax legislation.

We are deeply sympathetic to the problems faced by your committee, the Congress as a whole, and the Administration in attempting to cope with an apparently non-responsive economy, and to limit the amount of projected deficits for the next fiscal years. To that end, the comments we submit for your consideration cover a limited number of areas only. However, they are areas in which we believe there are structural deficiencies in Treasury's proposals or approach, or where we feel the results anticipated by Treasury will not, in our judgment, be accomplished.

Accordingly, we are pleased to submit our thoughts in four areas:

1. Repeal or modification of the completed contract method of accounting.
2. Acceleration of corporate estimated tax payments.
3. Statutory repeal of tax benefits from modified coinsurance.
4. International ramifications of the proposed corporate alternative minimum tax.

We appreciate the opportunity for our comments to be considered by the Ways and Means Committee. If any committee member, or staff person, would like to explore these views further, we would be happy to do so, using the firm's specific expertise on the appropriate subject.

Sincerely,

GERALD W. PADWE,
Associate National Director, Tax Services.

MODIFICATION OR REPEAL OF COMPLETED CONTRACT METHOD

As one of the more important "loopholes" sought to be closed by the Administration tax proposals, the completed contract method of accounting—for the reporting of income on long-term contracts—has come in for particular attention; with plans

to repeal the method and dramatically change tax reporting in this area, by both legislaton and regulation. While we believe there is definite room for tightening the completed contract rules, and that such tightening would produce an acceleration of tax revenues, we have great concern that the proposal for total repeal—not to mention placing long-term contractors on a substantially worse tax footing than other businesses with respect to period costs—is ill advised. We are not convinced the economic impact of the proposals has been completely thought through and we believe that the alternatives—regulatory and legislative—will have far reaching results rather different from those being suggested by Treasury.

The completed contract method, even if looked at today as a "loophole", is hardly a new concept in the Internal Revenue Code. For construction contractors, it has been a recognized method of tax reporting since 1918; for manufacturers, the method has been permitted since 1971, and that change for manufacturers was based upon negotiations with the Treasury Department at that time. Interestingly, one of the reasons for permitting completed contract for manufacturers was the perceived difficulty by IRS agents and Appellate conferees of agreeing on estimates of completion in the then commonly used percentage of completion method. Yet, under Treasury's present proposals, the percentage of completion method is one of only two which will be permitted contractors. We think it appropriate to ask why, given a 64-year history of acceptable tax reporting under the completed contract method, the entire method is suddenly seen as a loophole or an abuse, to be repealed entirely.

Turning to the rationale for eliminating this method of tax reporting for contractors, we would like to challenge one argument, in particular, as somewhat disingenuous; especially given the fact that we are engaged in the practice of accounting. The Treasury General Explanation on "Reasons for Change" points out:

"The completed contract method permits income to be deferred for tax purposes long after payments are received and *long after income is deemed earned according to standard accounting practices.*" (Emphasis supplied.)

That statement, while correct, is not the whole story. For example, we wonder whether Treasury would, as enthusiastically, support an acceleration in the timing of certain deductions in the Internal Revenue Code, on the ground that present tax practice defers the deduction until long after the expense is claimed according to standard accounting practice. We suspect not, and ask you to recall that as recently as 1979, the Internal Revenue Service was upheld by the U.S. Supreme Court (in the *Thor Power Tool* case) in denying taxpayers a deduction for certain excess inventory costs on the grounds (among others) that generally accepted accounting principles were irrelevant in the face of Treasury regulations taking a different view.

We believe the analogy not misplaced. If financial reporting practices have little or no bearing on the deduction side of the ledger, we would suggest the same is true in terms of using such an argument for support on the revenue side.

As to the substance of the Administration proposals, we do recognize some of the concerns sought to be addressed, and agree they can be dealt with by regulatory change. Clearly, the regulations presently in place did not contemplate the ability of contractors to maintain a contract in an incomplete status for 10 or 20 years. To the extent that this result is supported by artificial means, it is appropriate to seek change in regulation, though we do not see the need for legislative action. The treatment of indirect costs as period costs versus expenses capitalized as part of the contract, is a most difficult one, though one we can also see as being the subject of regulatory proposals (not legislative ones). And, the aggregation and severability issue presents another area for regulatory review and tightening.

We part company with the Administration, however, in the application of and anticipated results from certain aspects of the proposed changes. First, the treatment of period costs—in both the regulatory and legislative proposals—would put contractors in a worse tax position, vis-a-vis such expenses, than any other businesses we can immediately think of. Non-manufacturing taxpayers not using long-term contracts generally write off period costs immediately against income for tax purposes. Manufacturers, on the other hand, are required to allocate a number of period costs to inventory, to be recovered as a cost of sales deduction when the inventory is sold.

To a certain extent, then there is a parallelism between the treatment of period costs proposed for contractors and that presently used by other manufacturers. But no taxpayers, other than contractors, would be required to allocate interest and all general and administrative expenses to inventory, thus deferring their deduction. These are two major items: in the defense industry, for example, general and administrative expense will generally run from 10–15 percent of aggregate contract revenues. Non-contractors (even manufacturers) can deduct all or most of these

costs directly; why such draconian rules are needed for contractors is a case we do not believe the Administration has yet made.

Aside from the conceptual question of why manufacturing contractors are to be treated worse than their non-contracting peers with respect to such important items as discussed above, we believe the proposal will cause an administrative nightmare. In the defense industry, where a manufacturer may have 20 or 25 projects in process at one time, with borrowing levels rising and falling during the course of a year to meet overall cash flow requirements, how the allocation of interest costs among those contracts is to be done, we suspect, will cause a lot of revenue agents and a lot of taxpayers numerous sleepless nights. The allocation of other period costs will undoubtedly cause similar problems.

The above accounting changes with respect to indirect costs are to be accomplished by regulation. We note, however, that a most pervasive change is proposed to be imposed by statute. It provides that, for any long-term contract, the only allowable tax reporting will be the progress payment or percentage of completion method. In other words, taxpayers will no longer be able to use the accrual method or the cash method of accounting for long-term contracts, even though they have been entitled to do so in the past. This is a matter of real concern, particularly as applied to smaller contractors. For ease of record keeping, many of them use the cash or accrual basis whereas, on the other hand, very few contractors with substantial revenues (more than a few million dollars) use the cash or accrual method. Outlawing these traditional methods of tax accounting is not only harsh, but will have the likely effect of harming, primarily, smaller businesses.

At this point, we turn to the progress payment and percentage of completion proposals. In our view, neither will accomplish, completely, its intended effect, largely because we believe each will be used by a different important segment of the taxpayer class at which the changes are directed.

First, turning to the progress payment method, those electing its use will have to determine profitability on a contract-by-contract basis. Contracts where the right to receive progress payments in a year exceeds costs allocable to that contract will produce taxable income reportable in the year. Contracts, on the other hand, having costs incurred in excess of a right to receive progress payments will not be permitted either to reflect a deduction for the excess costs or to offset them against interim profits from other contracts. No contract losses may be recognized for tax purposes until costs incurred on a contract exceed the total payments taxpayer is entitled to the end of that contract. This "heads I win, tails you lose" approach will undoubtedly persuade taxpayers to utilize the percentage of completion method, where interim losses as well as interim profits are recognizable—at least if they would show interim profits on many of their contracts.

Certainly, we would expect the above argument to be true with respect to the construction industry. Sound business practice in that industry calls for overbilling at the front end of a contract, with the result that most such contractors will likely choose the percentage of completion method over the progress payment method. Even on profitable contracts, most in the construction industry would find the tax impact of progress payment more burdensome than percentage of completion; where interim losses occur, the use of the progress payment method becomes even more burdensome to a construction contractor.

We have no way of knowing the assumptions on which the Treasury Department based its revenue estimates from repealing the completed contract method, or how each one interacts with the final revenue estimates. However, to the extent those assumptions are based on the use of the progress payment method by the construction industry, we think they are too high. And, according to the Treasury General Explanation, construction industry output represents 35 percent of annual contractor output in our economy.

With respect to the defense and aerospace industry, where even larger revenue changes are likely to occur, we believe those estimates are also too high, though for a different reason. Unlike construction contractors, defense and aerospace contractors probably will adopt the progress payment method. In their case, current practice—at least in defense contracts—provides for progress payment reimbursement of only 90 percent of total costs (a few years ago it was only 80 percent; the 90 percent figure is actually an improvement over prior practice). Further, as units are delivered under the contract, reimbursement is normally made at an average unit cost—despite the fact that the "learning curve" produces far greater costs per unit at the beginning of a contract than at the end. Thus, defense contracts generally will not provide income recognition, on the progress payment method, until the contract is fairly close to being complete (say, 75 percent). In other words, legislative repeal of the completed contract method, as opposed to the regulatory changes under consid-

eration, will have very limited impact in accelerating tax revenues for this highly important sector of the U.S. economy. (Treasury estimates defense/aerospace output as 50 percent of output of the entire contract or class.)

There is another, most important, economic aspect of these proposed changes which we would ask Congress and Treasury to consider most carefully. Whatever change is made—be it repeal of completed contract altogether, modification of the deduction rules for indirect costs, or both—Treasury is certainly correct that the overall effect will be an increase in tax revenues. What we think should be considered somewhat further is who is going to finance that increase.

To begin, it should be noted that the revenues involved represent an acceleration of taxes rather than truly new taxes: the same profit is being subjected to tax, but that tax may no longer be deferred until the contract is completed. Still (and Treasury has recognized this in their General Explanation of these provisions), even an acceleration of tax revenues produces true incremental costs, arising either from the need for additional financing of the contract or the loss of opportunity cost returns from the deferred taxes. In the example used by Treasury in its General Explanation, a contractor engaged in a five year contract, and having an after-tax borrowing cost of 10 percent, would produce 15 percent higher profits were he able to use the completed contract method rather than the progress payment or percentage of completion method, charging the same price.

Thus, contractors would seem to have two choices: reduce profit margins or pass the incremental costs—in whole or in part—to purchasers. If profit margins are reduced, so are Treasury tax revenues. If incremental costs are passed on to customers, one of the most important customers of the defense industry is an entity known as the U.S. government—which means that Treasury is obtaining increased tax dollars in one pocket, but paying some of them out to those same contractors from another pocket.

There are other important customers for the products of long-term contracts. For example, some of the additional costs would be passed on to the commercial airline industry for the acquisition of new airplanes. Yet, the press reports that too many of these companies are in severe financial straits, and a few seem near bankruptcy. Is this an appropriate segment of the economy for the government to impose additional financial burdens on?

Another economic "beneficiary" of these proposals would be that part of the construction industry engaged in urban residential development. Single-family housing would probably not feel much of an effect, but what of apartment buildings, condominiums, etc.? It seems clear that costs to city dwellers for the rental or purchase of an apartment will, inevitably, have to increase, under the new rules; and again it seems appropriate to ask if that is the part of the economy best able to deal with additional financial burdens.

In short, we believe the full range of effects from repeal and modification of the completed contract method needs to be considered more carefully. There are parts of the proposal that can, indeed, close true "loopholes" in the way the method operates. The method itself, in the tax law for over 60 years, should not be done away with without substantially more study and understanding.

ACCELERATION OF CORPORATE ESTIMATED TAX PAYMENT

We wish to register our strong disagreement with the Administration's proposal to accelerate corporate estimated tax payments by imposing a penalty for failure to pay in currently 90 percent, rather than the present required 80 percent, of estimated taxes during the course of a corporation's current year. In our view, Treasury's perceptions and assumptions with respect to this issue are incorrect. Further, there will be some administrative burden added to the corporate accounting function in exchange for a relatively small return to the U.S. government; and—worse—the proposal represents, essentially, a one-time adjustment, followed by the need for indefinitely continuing the added administrative burdens just to "stay even" with the one-time revenue bump for Treasury.

The Treasury Technical Explanation for this provision presumes ". . . the ability of corporations to estimate their income on a monthly basis . . ." This may or may not be accurate for Fortune 100 companies, but it almost certainly is not accurate for medium and smaller size businesses. Even though estimates of financial income may be made monthly, it is no great secret that differences between financial and taxable income can be substantial; and it is undoubtedly a significant minority of corporate taxpayers that routinely prepare monthly taxable income estimates (which would now be required to be accurate within 10 percent). Just accounting for book-tax differences; adjustments for intercompany transactions where corporations

are filing a consolidated return, where adjustments and eliminations are different on a tax basis than on a book basis (or where they file consolidated financial statements but separate returns, and it now becomes necessary to restore the intercompany eliminations and adjustments for tax purposes); the difficulty of obtaining accurate monthly or quarterly information—on a book, much less a tax, basis—where foreign operations are involved; all speak to the practical improbability of arriving at taxable income estimates for each tax quarter that can fall within a 10 percent range. In fact, given the complexity of today's tax laws, many corporations have difficulty obtaining current information accurate within the presently permitted 20 percent tolerance, and thus fall back on one of the safe harbor exceptions to avoid penalty. With only a 10 percent tolerance, and with the trend (at least for large corporations) toward eliminating safe harbor exceptions, an increased number of underpaid taxpayers may be anticipated.

Combined with this is an unusually strong sanction for failure to estimate within the 10 percent range: a nondeductible penalty charge which, at present, is at a 20 percent annual rate. For a corporation in the top, 46 percent, bracket, such a charge is the equivalent of 37 percent annual interest. In our view, therefore, the medicine is too strong for the illness.

While it may be argued that there is not that much difference in terms of administrative attention required, between an 80 percent and a 90 percent test to avoid underpayment penalty, our experience as tax practitioners speaks differently. For individuals, the Internal Revenue Service will grant an automatic extension of time to file Form 1040, normally due April 15, but only if taxpayer has paid at least 90 percent of his final tax liability by the time the extension request is filed. If the 90 percent test is not met, penalties will normally be asserted for late payment of tax.

Our experience has been that the need to compute final liability within a 10 percent tolerance is often so difficult that it requires as much work to obtain the extension as to file the actual Form 1040. Clearly, a 20 percent margin for error would give substantially more than twice the confidence level that tax would not be underpaid than would a 10 percent margin—and in our situation, we are talking about meeting the 90 percent test 3½ months after the year closes. Imagine a corporation trying to make such determination, within 10 percent, by the middle of the fourth month of the current year, with 7½ months still to go before the year closes.

Thus, if the proposal is enacted, it strikes us the likely result will be the need for providing still tighter accounting controls than presently exist, enabling corporations to currently extract, on a more accurate basis, the type of information required to avoid the penalty. For many companies with internal tax staffs, this will mean additional hours spent (at additional corporate cost) to obtain this information. For those companies without their own tax staffs (and that is certainly the large majority of corporate taxpayers), it will undoubtedly be necessary to increase legal or accounting fees for outside help in this area. Even so, with only a 10 percent tolerance as opposed to the present 20 percent, many more taxpayers will underpay and be subject to the penalties involved. For an Administration that has promised to get government off the backs of the American people, this proposal is hardly a step in that direction.

What we find particularly unfortunate about it is that, while it certainly will increase the timing of cash flow to government, the timing represents, basically, a one-time benefit to Treasury: after the first year, in which there is a true cash flow speed-up, the same administrative procedures must be carried out annually forever in order just to stay even with the first year's acceleration. Thus, except for rising tax liabilities, the cash flow improvement only helps Treasury once.

We note that the revenue estimates prepared by Treasury provide an aditional $4 billion during fiscal 1983-1985. Thereafter, the next two years produce a net zero revenue flow and, in fact, by fiscal 1987 there is actually a small net loss to Treasury. It would be interesting to know, in these numbers, how much of the estimated additional revenue comes from underpayment penalties, rather than true acceleration of cash payments. We would expect those penalties to increase to some degree and, if there is any agreement on that score, it would seem inappropriate to impose a tax provision that could be extremely difficult for taxpayers to comply with, but would then result in producing additional revenues to government through penalties for noncompliance.

REPEAL OF MODIFIED COINSURANCE PROVISIONS

We would strongly urge the Congress, despite the attractiveness of revenue gains from repealing the ability of life insurance companies to use modified coinsurance (Modco) in reducing their taxes, not to enact such repeal at this time. In brief, life

insurance taxation is one of the most complex areas of the Internal Revenue Code. The present system for taxing life companies has been in place since 1959, and section 820 (the section sought to be repealed) is but one of many special provisions which treat life insurance companies as different from casualty insurance companies, and vastly different from non-insurance corporations.

Even if the 1959 system is obsolete or badly in need of overhaul (an issue we do not here address), we believe taking only one part of that system and eliminating it for revenue raising purposes is to deal with a symptom only. The proper approach is a complete review of the tax system as it applies to life insurance companies, and a bringing of that entire system up to date.

Treasury's General Explanation of this provision states: "The modified coinsurance provision of the Code was never intended to produce large tax benefits for insurance companies. The Federal corporate income tax paid by the largest mutual life insurance companies fell by 35 percent from 1979 to 1980, and by more than 40 percent from 1980 to 1981. The primary reason for this reduction is modified coinsurance."

Our concern with the above quotation is that, while in no way challenging its accuracy, it presents only one side of a much more complicated story. We feel it appropriate to ask why mutual life companies have felt it necessary to reduce their tax burdens through Modco, before deciding that such reduction is unwarranted. And, in very simplified form, one answer is that the operation of another part of life insurance tax rules has so increased the tax burden on these companies, in a manner not foreseen when the rules were put in place in 1959, that prudent planning to protect reserves needed for future insurance claims has been directed to other ways of decreasing taxes.

Life insurance company investment income is subject to tax at top corporate rates; i.e., a 46 percent maximum. In determining taxable investment income, a reserve interest deduction is permitted, calculated mechanically on the so-called "10 for 1" formula. The formula contrasts the actual investment earnings rate with an assumed reserve rate, and the difference between the two is used in arriving at a reserve adjustment factor which, in turn, becomes an important point in calculating the reserve interest deduction (the formula is called the "10 for 1" formula, because each one percentage point increase in the rate of actual investment earnings requires a 10 percentage point decrease in applying the reserve adjustment factor).

Traditionally, the assumed reserve rate for the industry has been around 3 percent, and part of the reason for it being so low involves ceilings imposed by State statutes. However, using the 3 percent assumed reserve level, the 10 to 1 formula results in the reserve interest deduction being computed along a parabolic curve on which the interest deduction increases, along with actual investment earnings, until the actual earned rate is 6.5 percent; thereafter, continuing along the curve, although the actual rate and actual earnings continue to increase, the deduction decreases—absolutely, not just proportionately—with the effect that each additional dollar of gross investment income produces more than $1 of taxable income. Thus, the marginal rate of federal income tax on investment earnings will go beyond the statutory rate when the life insurance company's actual investment earnings rate gets to 7 percent. If that gets to 13 percent, no deduction at all is allowed for reserve interest, and the marginal rate on investment earnings will be close to 100 percent (under certain circumstances, it will exceed 100 percent).

With that background, let us look at the situation today. The current, industry-wide, actual investment earnings rate was 7.00 percent in 1977, 7.39 percent in 1978, 7.78 percent in 1979, and 8.06 percent in 1980. Thus, for the past four years, but for taking other actions, life companies would have incurred marginal tax rates on investment income in excess of 46 percent. The current Administration, and many in Congress, argue that businesses and individuals make investment decisions on the margin, and marginal tax rates are extemely important. Perhaps, attempts by mutual life companies to reduce marginal rates on investment income (through modified coinsurance, for example) is just an early recognition that supply side economics is not new to business.

It should be noted that, no matter how high investment earnings rates go, the mechanics of the reserve interest deduction formula assure that the effective tax rate on investment income will not exceed 46 percent, even though the marginal rate may be at around 100 percent where the actual earnings rate is 13 percent. Still, we do not believe that is a sufficient answer to the above points on marginal rates. For example, in 1959, and for a few years thereafter, the actual earnings rate on investment income was around 3 to 4 percent rather than the 8 percent of today. Because of the 10 to 1 leverage in the formula, a 3 percent rate contrasted with the 3 percent assumed rate would produce an effective tax rate on investment earnings

of a little over 4 percent. A 4 percent actual earnings rate would increase the marginal rate to about 24 percent, but the effective rate would still be just over 9 percent. Contrast this with today's situation, where an 8 percent actual earnings rate produces approximately a 53 percent marginal tax rate on those earnings, and an effective tax rate of about 26 percent. If the actual earned rate were ever to get to 12 percent, the marginal tax rate would be around 83 percent and the effective tax rate about 41 percent.

Obviously, it is correct that higher actual earnings rates produce higher investment earnings. Still, the significantly greater percentage of those earnings going to federal income taxes causes management to seek ways of otherwise reducing the tax burden, such as Modco.

We are not arguing that the present tax treatment of modified coinsurance, per se, is good or that it must be maintained. But, we are pointing out that Modco is a symptom of a much larger problem: the need to readdress the viability of the 1959 Life Insurance Tax Act as it meets the needs of government and the industry in today's economic climate. We are aware that the insurance industry has put a proposal before Treasury, and is trying to negotiate a stop-gap measure with them. Without, in any way, taking sides on that proposal, or as to what the tax rules applicable to life companies should ultimately be, we do feel it important that Congress not deal only with one particular aspect of what should be recognized as a highly complex problem.

ALTERNATIVE MINIMUM TAX FOR CORPORATIONS

The Administration has presented an alternative minimum tax proposal to Congress, and others (including the Chairman of the Finance Committee) have also expressed interest in the concept. We recognize the interest of both branches of government in reducing deficits by all prudent means, and are aware that those industries which feel particularly the subject of this proposed tax will be heard by your committee.

The points we would like to make, however, are not industry related. In reviewing the Treasury explanation, and becoming aware of possible different approaches to the treatment of the foreign tax credit in a corporate alternative minimum tax system, we believe there are a number of international tax ramifications involved in this entire area. Further, the evolution and complexity of the foreign tax system for individuals, enacted in 1978, makes it clear that this is the most appropriate time to both consider these issues and attempt their early resolution.

To start with the obvious, the minimum tax may have an adverse effect on the flow of capital and business into the United States to the extent the proposed minimum tax would create an additional cost for foreign corporations engaging in business here. We concur, however, that if the U.S. has a significant corporate minimum tax, that tax should fall equally on U.S. business income of U.S. and foreign persons.

The application of the new minimum tax to foreign corporations may, to some extent, be limited by the provisions of U.S. tax treaties. U.S. income tax treaties require the presence of a permanent establishment in the United States before the regular corporate income tax applies to the U.S. business income of a foreign corporation resident in a treaty country. Business income exempt from the regular corporate tax by reason of a treaty should not be subject to the minimum tax; the treaty, not preference items, has reduced U.S. tax in these circumstances. This treatment of the minimum tax will be assured if the proposed minimum tax is considered a "covered tax" for purposes of U.S. income tax treaties.

Another question of international significance is how the proposed minimum tax will apply to the foreign operations and income of U.S. corporations. Relevant to this issue is how, if at all, the current and proposed tax preference items relate to foreign activities and foreign income, and whether a foreign tax credit would be available to reduce the proposed minimum tax.

We are pleased that the Administration has proposed allowing the foreign tax credit to be an offset against the minimum tax. It is appropriate for the new alternative minimum tax to allow a foreign tax credit if this new tax is to apply to foreign income. For over 60 years, the United States has used the foreign tax credit mechanism to avoid international double taxation of foreign income. The objective of avoiding double taxation and the tool of achieving that objective, the foreign tax credit, are just as important to a minimum tax that falls on foreign source income as they are to the regular corporate tax.

Press reports suggest that some may favor making the foreign tax credit a preference item, eliminating it as an offset against the minimum tax, or allowing foreign

taxes paid as a deduction against the minimum tax base. We believe it would be unwise to take such action, as failure to grant appropriate parity for foreign taxes might well put affected U.S. taxpayers operating overseas at a competitive disadvantage.

However, controversial as it might appear on the surface, we believe there are arguments to be made (see below) that the corporate alternative minimum tax should not apply at all to foreign source income. And, if the committee eliminated foreign source income from the minimum tax base, then there would be no need for a foreign tax credit against the minimum tax. (As used here, the term foreign source income does not include deferred DISC income. Deferred DISC income usually bears very little foreign tax and, therefore, not allowing a foreign tax credit against a minimum tax on such income would usually not create a hardship. The committee could assure no undue hardship, however, by reducing the amount of deferred DISC income treated as a preference to account for any foreign taxes imposed on such income).

There are several reasons why the committee should consider limiting the minimum tax to U.S. source income. Most of the current and proposed preference items relate principally, if not solely, to U.S. activities and income. Two preferences that are likely to be relevant to U.S. tax on foreign source income—percentage depletion on minerals other than oil and gas, and capital gains—have already been focused on to some extent through adjustments in the foreign tax credit limitation (Sections 901(e) and 904(b)). And, many U.S. corporate taxpayers are paying more foreign taxes than they can credit against the corporate tax. Thus, the proposed mimimum tax may have only a nominal effect on foreign source income of corporations, or affect only select groups of corporations. Second, exempting foreign source income from the minimum tax eliminates the considerable complexity of having special foreign tax credit computations for purposes of the minimum tax. Third, the proposed minimum tax is inherently inequitable, at least in comparing foreign branches and foreign subsidiaries, in that any preferences benefiting U.S. shareholders of foreign subsidiaries by accelerating the deemed-paid foreign tax credit are not—and without enormous complexity cannot be—subjected to proposed minimum tax. A U.S. taxpayer operating overseas through a branch may, in contrast, be exposed to the proposed minimum tax to the extent preferences reduced the branch's taxable income. Finally, and most important, the U.S. tax effect of any preferences relevant to foreign income cannot be assessed without examining how the foreign tax credit rules applicable to the corporate tax interact with and are affected by those preferences.

In conclusion, if the committee believes that the U.S. collects too little corporate tax on foreign source income because of a few preferences and the operation of the foreign tax credit, we would suggest that the committee consider holding hearings to discuss how if at all, the corporate tax should be amended.

Statement of the U.S. League of Savings Associations

We appreciate this opportunity to comment on the President's revenue increase proposals included in the Administration's fiscal year 1983 budget, as well as other recommendations for improved tax collection and enforcement.[1] The savings and loan business, Mr. Chairman, is concerned about our nation's prolonged high interest rates which are creating an economic and financial crisis. In order to bring interest rates down, immediate action must be taken to reduce massive federal budget deficits. More than anything else, it is the spectre of an overwhelming volume of deficit financing which haunts housing and financial markets and poses the threat of economic and financial markets and poses the threat of economic and financial conditions not seen since the 1930s.

Given these circumstances, there is no alternative to: (1) slowing down all spending, not excluding defense and entitlement programs; and, if necessary (2) deferring previously enacted tax reductions or increasing taxes. Recommending increased

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[1] The U.S. League of Savings Associations has a membership of 4,100 savings and loan associations representing over 99 percent of the assets of the $650 billion savings and loan business. League membership includes all types of associations—Federal and state-chartered, stock and mutual. The principal officers are: Roy Green, Chairman, Jacksonville, FL: Leonard Shane, Vice Chairman, Huntington Beach, CA; Stuart Davis, Legislative Chairman, Beverly Hills, CA: William B. O'Connell, President, Chicago, IL; Arthur Edgeworth, Director, Washington Operations; Glen Troop, Legislative Director; and Phil Gasteyer, Associate Director, Washington Operations. League headquarters are at 111 East Wacker Drive, Chicago, IL 60601. The Washington office is located at 1709 New York Avenue, N.W., Wash., D.C. 20006.

taxes does not include supporting a withholding plan whose cost to the private sector far exceeds its expected revenue benefit to the Treasury.

Even with these actions, the restoration of financial stability and safety will be a slow process. it is necessary, therefore, to adopt immediate but temporary measures to address the critical problems of the industries which finance, market and produce housing for American families. These industries have unfairly borne the brunt of destructively high interest rates. Unless immediate and effective short-run measures are adopted, the continued devastation of these industries will, directly and indirectly, aggragate the federal budget deficit and greatly increase the prospect of a general economic and financial crisis.

Therefore, Mr. Chairman, while we support the President's call for further revenue increases, we disagree strongly on the source of those increases.

Our testimony will: (1) oppose the President's plan to withhold taxes on interest paid to savers at financial institutions; (2) request that the tax loss carryforward provision of last year's Economic Recovery and Tax Act be granted to savings and loan associations; (3) provide a preliminary evaluation of the performance of the All Savers Certificate; (4) propose changing the savings and loan institution's tax law definition; and (5) support with exception the Tax Compliance Improvement Act of 1982.

WITHHOLDING

The U.S. League of Savings Associations strongly opposes this Administration's withholding plan because it suffers from a number of important public policy limitations.

First, the proposal does not relieve the Treasury of the responsiblity of improving their reporting or audit procedures.

Second, the Treasury's revenue gains from accelerated payments and increased compliance are suspect.

Third, the proposal will impose an additional burden on our savers who, for the most part, are elderly.

Fourth, this proposal threatens the foundation of our tax system based on voluntary compliance.

Finally, but most importantly, the cost of implementing withholding by our institutions will far exceed the Treasury revenue gain.

The U.S. League agrees with the Treasury that illegal or inadvertent tax evasion is indefensible. In support of this position, the savings and loan business, through its 1099 interest reporting program, has made major efforts in assisting the Treasury to improve compliance. Internal Revenue Service estimates, based upon 1976 income, show that 84 percent of interest income was reported to the IRS that year. Since then, a substantial increase in magnetic tape reporting has ocurred among financial institutions which probably raises the 1976 estimate of reportable interest income to over 90 percent. By perfecting our system of 1099 reporting, the savings and loan business faithfully supplies both the IRS and the depositor with the necessary annual information to pursue those taxpayers who have a tax liability on their interest income. Until this information is fully utilized through matching by the IRS, however, the government shouldn't transfer the burden of interest income tax collection to the financial community.

It is our view that the basic problem of noncompliance will not be solved by withholding nor will it eliminate the burden and expense of current interest reporting. What must be done is to appropriate the funds necessary for the IRS to utilize the tax information already made available to it. In addition, our existing system can be improved by making 1099 reporting universal. To accomplish this, 1099 reporting must be extended to interest payments made to individuals on all securities of a type generally offered to the public, including treasury and bearer obligations. These changes, along with a more thorough matching system when this information reaches the IRS, will insure greater compliance in the taxation of the U.S. interest income.

The U.S. League wants Congress to recognize that this system of Treasury withholding—calling for use of exemption waivers, annual withholding options, and development of a potentially unfeasible system for withholding on marketable debt securities—will not achieve the revenue estimates either through acceleration or compliance which are suggested by Treasury.

Indeed, since individuals will be able to make adjustments to avoid interest overwithholding or reduce their estimated tax payments (if they estimate) by the amount of taxes on interest withheld, the Treasury estimate of $1.4 billion in accelerated tax payments for fiscal year 1983 is incorrect. Likewise, the $500,000 figure

for increased compliance relies partially upon implementation of a difficult withholding scheme on bearer obligations and other marketable debt securities. If this proves unworkable as many suspect, then the half a million dollars in increased compliance will also be scaled down.

The Treasury claims that consumer harassment will not occur because of withholding. To the contrary, the complex system of exemptions will require notification, explanation, application and exemption updating when a change in status occurs. Let there be no doubt that any withholding system with the necessity of exemptions will be a harassment to savers, particularly our savers who are elderly and, therefore, must involved in the exemption process.

In line with this question of consumer harassment is the important issue of voluntary compliance with our nation's tax laws. A complex and inefficient system of interest withholding will be looked upon by the American people, already overburdened by taxation, as a petty and punitive plan. The question must also be asked, will this proposal cause taxpayers to join the ranks of our nation's underground economy in order to legally or illegally avoid or evade taxes? We believe the benefits of withholding do not justify this risk to our voluntary tax system.

Finally, the operational difficulties and costs of implementing this withholding proposal would be substantial. Four cost elements come immediately to mind. First, there would be the initial setup costs for computer programming and the exemption waiver system; second, the annual maintenance for the withholding system; third, liquidity costs for associations; and, fourth, complications arising from the application of withholding to N.O.W. accounts.

The U.S. League estimates that development of an operational system of withholding and a workable system of exemption waivers and account coding would cost approximately $435 million at our nation's savings and loan associations. Once established, a withholding system involves maintenance and updating. This involves the ongoing costs of withholding on open accounts and the costs for new, closed, or transfered accounts. The cost of these maintenance processes is roughly $325 million "per year" for just our savings and loan association. In addition, any withheld funds from our institutions transmitted to Treasury obviously will involve a liquidity cost. Assuming a 5 percent level of withholding, the liquidity replacement cost would exceed $30 million at our associations. Thus, whatever the expected Treasury revenue increase from withholding at our institutions might be, our enormous costs both initially and annually will make this program clearly not cost effective.

With regard to operational difficulties, institutions withholding on N.O.W. accounts will incur numerous problems. The N.O.W. account is highly volatile with balances varying substantially from day to day and week to week. Therefore, customers must maintain sufficient balances in their transaction account to cover withheld funds since Treasury insists that these account balances never fall below an amount equal to the deferred withholding. Unfortunately, it is not known in advance what amount of interest or amount of withholding will occur at the end of an interest payment period whether it be quarterly or annually. Thus, the financial institution is unable to program its system to insure against insufficient balances and the depositor is unable to do his financial planning because he is unaware of his account balance at the time of withholding. As a result of these anticipated operational difficulties, we will probably increase over-drafts and their related depositor embrarassment, non-sufficient funds charges an unnecessary over-draft borrowing costs.

FEDERAL INCOME TAX LOSS CARRYFORWARD PERIOD

Under the Economic Recovery Tax Act of 1981, the carryforward period for net operating losses for most businesses was extended to 15 years with respect to losses incurred in taxable years ending after 1975. We believe it is critical that the loss carryforward period for thrifts, now limited to 5 years, be extended to this 15-year period for the following three reasons:

(1) To provide an incentive to the troubled merger process for savings and loans and mutual savings banks;

(2) To assist in the recovery process for those institutions that survive the current disastrous economic environment; and

(3) To give positive assistance to the decision-making process with respect to deferring losses.

The merger process would be greatly benefited by virtue of the fact that losses incurred by acquired thrifts in the early years after acquisition could be effectively utilized against profits occurring at a later time when restructuring takes place. Although purchase accounting provides a needed boost to book earnings in the early

years following the acquisition of a troubled thrift, tax losses continue to be generated due to the fact that the pre- or post-merger tax accounting method of the acquired institution will not produce the positive earnings results generated under purchase accounting. Therefore, since net operating losses continue to be generated by the acquired thrift and also possibly the acquiring institution, significant tax loss carryforwards could accumulate, with the write-off expiring after only five years. Thus, by extending the tax loss carryforward period to 15 years, an acquiring institution, faced with its own operating problems over the next several years, could reasonably plan on a future tax benefit from the present losses being incurred.

An institution that is currently experiencing tax and/or book operating losses, has probably exhausted its carryback capacity or is usually considering whether or not to start a restructuring process by disposing of below-market loans or investments using the newly permitted deferred loss accounting method permitted by the FHLBB. However, it may not execute the transaction due to the fact that, for tax purposes, additional losses are created which cannot reasonably be expected to be utilized over the present loss carryforward period. Since tax benefits attached to a tax loss program can offset approximately 30 percent of the losses recognized, then it is important for one's business judgement to know explicitly what tax benefits are available.

If this loss carryforward period were significantly extended, the financial institution would have more business and operational flexibility because they would receive a needed tax benefit from offsetting their operating tax losses against future income. This additional business flexibility would be most helpful to a troubled savings and loan industry facing our current economic environment.

PERFORMANCE OF THE ALL SAVERS CERTIFICATE

The All Savers certificate was designed to accomplish three primary objectives:

(1) provide a tax incentive for saving;
(2) provide a cost-of-funds relief for depository institutions; and
(3) encourage increased home mortgage lending.

The order of priority of these objectives and the degree of the certificate's success depend largely upon one's point of view. Realtors and homebuilders evaluate the success of the certificate in terms of increased home mortgage lending, depository institutions in terms of reducing their cost of funds, and advocates of tax incentives for saving in terms of its ability to induce individuals to save more from current income.

The U.S. League believes it is important to evaluate the actual experience of the All Savers certificate in the context of the environment into which it was introduced and with reference to its performance relative to other savings instruments and not previous savings flow claims.

Since June 1978, four new savings certificates have been authorized for issuance by depository institutions—the 6-month Money Market certificate (MMC), the 30-month Small Saver certificate (SSC), the 12-month All Savers certificate (ASC), and the 18-month Individual Retirement Account certificate (IRA). Table 1 shows the growth of each of these new certificates over the first few months following their introduction.

TABLE 1.—CUMULATIVE BALANCES FOR MMC, SSC, ASC, AND IRA, FIRST 5 MONTHS, ALL DEPOSITORIES

[In billions of dollars]

Month	MMC [1]	SSC [2]	ASC [3]	IRA [4 5]
1	9.1	8.5	32.6	2.9
2	20.8	13.7	40.0	.....
3	27.9	17.4	42.9	.....
4	35.1	26.4	45.4	.....
5	50.2	40.1	.....	.....

[1] Beginning June 1978.
[2] Beginning January 1980.
[3] Beginning October 1981.
[4] 18-month certificate only.
[5] Beginning January 1982.

Source: Federal Reserve Board.

After an extremely warm reception in its opening month, ASC growth has slowed markedly. In spite of this decline, the ASC nevertheless drew the largest deposit inflow in its initial month of any new certificate and remains ahead of the MMC and SSC at the same stage. The MMC and the SSC took about four months to reach balances equivalent to the first month of the ASC. Differences in these growth patterns are, at least to some extent, explained by differences in the economic environment at the time each new certificate was introduced.

The MMC was introduced into a rising interest rate environment; MMC rates rose steadily from 7.45 percent in June, 1978, when the certificate was first offered, to 9.46 percent six months later. This rapid and substantial increase in yield followed a period of stable but gently rising rates, so that the MMC became increasingly attractive to savers.

The SSC was introduced in January, 1980, at a fixed rate of 9.0 percent, relatively low compared to the January, 1980, MMC rate of 11.8 percent. But interest rates went into a free fall in the spring of 1980, with MMC rates tumbling from 15.7 percent in March to 7.8 percent in June. By comparison, then, SSC rates, still at 9.0 percent, became increasingly attractive.

The ASC was introduced in October, 1981, into a declining interest rate environment following and continuing through a period of highly volatile interest rates. MMC rates had ranged from highs of 16.1 percent to lows of 11.4 percent in the preceding 12 months. The opening rate on the ASC was 12.6 percent, followed by rates of 12.1 percent, 10.8 percent, 8.3 percent, 10.2 percent, and 10.8 percent. Although these were after-tax rates of return, savers' perceptions of these yields clearly made the ASC less, not more attractive, given the experience with interest rate volatility in the period just preceding its introduction.

The MMC, ASC, and SSC all have short maturities compared to the IRA. Upon introduction in January, 1982, the 18-month IRA, which carries an unregulated rate of interest, was offered in the 13 percent to 14 percent range with either a fixed or a floating rate. These were tax-deferred rates, with the added incentive of tax deferral on the principal balance. THey therefore offered after-tax yields substantially above the other three instruments. Yet the initial response to the IRA was weaker than any of the other three.

One may surmise that there are several reasons for the IRA's slow start. It is a very long-term account, with no penalty-free withdrawal before age 19½; only $2,000 per person per year may be deposited; the deposit can be made at any time up to filing one's tax return and still receive full credit for that tax year. Given these characteristics, it is very easy for qualified IRA depositors to defer their decision.

Both the MMC and the SSC were introduced when the economy was relatively strong and interest rate volatility, job insecurity, and a general climate of economic uncertainty were absent. Exactly the opposite has been true for the ASC and the IRA. All three of these factors are at their most intense levels since the end of World War II. Consequently, savers' decisions to place their funds long-term are significantly affected. Even the definition of what constitutes "long-term" has been changed; it is a much shorter time than ever before and when the money market mutual fund alternative is available, savers are much more inclined to keep their funds readily accessible until the economy is again on a stable growth path.

The ASC and the IRA are also relatively complicated savings instruments. The saver's decision to choose either one depends significantly on after-tax yield comparisons. Inasmuch as the IRA has been offered at the equivalent of taxable rates even though the yield is tax-deferred, this factor should not be a problem for the IRA. Roughly speaking, the taxable equivalent return on an IRA at 14 percent for a taxpayer in the 50 percent marginal tax bracket is 71.0 percent per annum. (On a $2,000 IRA equivalent to $420 taxable interest dollars, and a $1,000 deferral of personal income tax liability.) At such rates of return, after-tax yield comparisons are hardly an issue.

This is not the case with the ASC, which is much less generous with the taxpayer. The tax-exempt yield on the ASC is set at 70 percent of the yield to maturity on the 52-week Treasury bill. Consequently, the tax-exempt rate on the ASC will always be below the equivalent taxable rate. The depositor's decision to invest in an ASC then must turn on whether or not the tax-exempt ASC rate is greater than the after-tax yield on alternative savings instruments.

Table 2 contains the average after-tax yield comparisons by marginal tax rate (MTR) for each of the seven ASC rates in effect through the first 5½ months of its existence (October, 1981 through March 8, 1982) against its three main alternative savings instruments—MMFs, MMCs, and SSCs. The MMF yield comparisons are based on the composite weekly MMF yield over the entire period following the effec-

tive date of the given ASC rate; the MMC and SSC average comparisons are based on the MMC and SSC rates prevailing during the four weeks during which the given ASC rate was in effect. The data in the table are expressed as percentage points. Positive numbers indicate the extent to which the tax-exempt ASC rate exceeds the comparable after-tax yield on the alternative instrument. Negative numbers, of course, indicate the opposite.

TABLE 2.—AVERAGE AFTER-TAX YIELD COMPARISONS AT VARIOUS ALL SAVERS' RATES AGAINST ALTERNATIVE SAVINGS INSTRUMENTS

[In percentage points]

Alternative instruments by marginal tax rate (MTR)	All savers rates—						
	12.61	12.14	10.77	8.34	10.16	10.76	10.79
50 Percent MTR:							
MMF	5.83	5.43	4.29	2.06	3.85	4.31	4.05
MMC	5.02	5.13	4.39	2.56	3.78	3.84	3.86
SSC	4.51	4.26	3.78	1.86	3.25	3.44	3.46
40 Percent MTR:							
MMF	4.47	4.08	3.00	.81	2.59	3.02	2.69
MMC	3.50	3.72	3.11	1.40	2.50	2.45	2.47
SSC	2.89	2.68	2.37	.56	1.87	1.97	1.99
30 Percent MTR:							
MMF	3.12	2.74	1.70	−.45	1.32	1.73	1.34
MMC	1.98	2.35	1.84	.24	1.23	1.06	1.08
SSC	1.27	1.11	.98	−.74	.49	.51	.53
25 Percent MTR:							
MMF	2.44	2.07	1.05	−1.08	.69	1.08	.42
MMC	1.23	1.62	1.20	−.34	.59	.38	.39
SSC	.46	.32	.27	−1.39	−.20	−.22	−.22
20 Percent MTR:							
MMF	1.76	1.39	.41	−1.71	.06	.44	−.01
MMC	.20	.91	.56	−.92	−.05	−.32	−.31
SSC	−.35	−.47	−.43	−2.04	−.37	−.96	−.95

To illustrate, a saver who deposited $10,000 in an All Savers certificate at 12.61 percent has, through March 8, earned annualized after-tax interest of $176 more in the ASC than in a money market fund if the saver is in the 20 percent marginal tax bracket, $244 more in the 25 percent bracket, $312 more in the 30 percent bracket, $447 more in the 40 percent bracket, and $583 more in the 50 percent bracket. Note that these returns are after-tax dollars.

On the basis of after-tax yield, the ASC shows a clear advantage over all of the alternatives at all ASC rates at the 40 percent and 50 percent marginal tax rates. This yield advantage also applies at the 30 percent marginal tax rate, except in December when the ASC rate reached a low of 8.34 percent. In December, the ASC showed a small yield advantage at the 30 percent marginal tax rate against the MMC, but not against the MMF or SSC. At the 25 percent marginal tax rate, the ASC also produced favorable spreads against the MMF and the MMC except at 8.34 percent. Even at the 20 percent marginal tax rate the ASC has at times beaten the MMC and MMF yields; only the SSC has consistently produced after-tax yields higher than the ASC at the 20 percent tax rate.

These yield comparisons strongly suggest the existence of a significant lag in saver recognition of the yield advantages of the tax-exempt All Savers certificate, not a failure of the certificate to produce those yield advantages across a broad spectrum of marginal tax rates. This recognition lag can only be closed by educating the saving public to after-tax yield comparisons. That is a task for marketing.

The ASC marketing effort was intense during September and October, 1981, and a record deposit inflow for a new savings instrument was the result. Marketing emphasis generally switched to the new universal IRA after October, however, on the theory that the IRA account would stay with the financial institution where it was opened. Financial institutions thus took "time out" from marketing the ASC (which expires on December 31, 1982) to attempt to attract and maintain a long-term (IRA) depositor base.

The IRA advertising blitz, coming so closely on the heels of a comparable ASC blitz, undoubtedly resulted in some degree of bewilderment among potential savers. Combined with the uncertainty created by a rapidly deteriorating economy, the consequence has been weaker results for both the IRA and the ASC than would otherwise be indicated by the after-tax yield comparisons.

SAVINGS AND LOAN TAX LAW DEFINITION

Congress approved in March 1980 the Depository Institutions Deregulation and Monetary Control Act (P.L. 96-221). Title IV of that legislation broadens the investment opportunities for federally-chartered savings and loan associations to help them prepare for the eventual deregulation of the savings markets and to enable them to broaden their investment mix to include assets which adjust more readily to inflationary periods. Today, other legislation has been introduced to further broaden savings and loan investment authority in order to make them more viable and competitive financial institutions.

While these changes in the "banking" laws are welcome, they are of limited utility unless corresponding changes are made in the definitional sections of the Internal Revenue Code which apply to "domestic building and loan associations". The current law requires that 82 percent of investments consist of "qualifying real property loans" if S&Ls are to fully utilize their permitted tax treatment. We would ask that list of qualifying investments reflect the changes already in law (P.L. 96-221) and provide for future investment flexibility by lowering the applicable qualifying investment percentage to 72 percent—a level, by the way, which currently applies to another type of housing-specialized thrift institution, the mutual savings bank.

TAXPAYER COMPLIANCE IMPROVEMENT ACT OF 1982

Finally, increased taxpayer compliance is an important objective and one the savings and loan business has advocated for years in the form of our 1099 interest reporting program. We support the effort of Mr. Conable to reverse the increasing compliance problem undermining our tax system. However, a few provisions contained in H.R. 5829 should be reconsidered. Specifically, the provision, which delays the starting date of interest to be received by all taxpayers suffering net operating losses until their refund claims are filed, will be particularly onerous to savings and loans this year. For example, depending upon the course of interest rates for the balance of this year, it is possible that every association in the country will be operating at a loss for tax purposes for 1982. In a general way, this proposal also disturbs the equitable balance between the government and taxpayers established by Congress more than 25 years ago and places substantial administrative burdens on those taxpayers.

The present rule provides that interest is paid on a carryback claim starting from the close of the taxable year which generated the loss or credit carryback. It has been a part of the Internal Revenue Code for over 25 years and was added to treat taxpayers and the government on a consistent basis for computing interest on refunds and deficiencies. Furthermore, the present condition, i.e., the statutory interest rate exceeds the market rate, may well be a phenomenon peculiar to 1982. We believe that this proposal, if enacted, will again create an inequity in favor of the government.

Moreover, the proposal raises the specter of tremendous tax return preparation problems for corporations which must accumulate the data for the return and for the preparers of such returns. In fact, as a result of this unanticipated proposal, our members will certainly be contacting their accounting firms to prepare immediately and file their 1981 Federal income tax returns so that they may file their carryback claims for refund and preserve the right to receive the full amount of interest allowed by present law. This burden on tax preparers will increase when the proposal becomes more generally known and the government may experience a problem in timely processing an accelerated filing of claims.

We suggest that the interests of orderly administration of the tax rules would be ill-served by this rush to file, especially in light of what we perceive to be the primary motivation for the proposal. You are apparently concerned that taxpayers are intentionally delaying the filing of their carryback claims because the Internal Revenue Code section 6601 interest rate of 20 percent exceeds the present prevailing market interest rate. While it is certainly true that taxpayers would rather receive than pay the 20 percent interest rate, your proposal to completely eliminate interest until the claim is filed assesses a penalty against taxpayers that far exceeds any perceived abuse.

For Congress to change a long-established rule to correct a perceived imbalance, which may exist for only one year, seems to us an overreaction. The potential for this situation to reoccur in later years should be minimal under your further proposal to adjust interest semi-annually. In addition, by completely eliminating all interest payable prior to filing a refund claim as proposed in H.R. 5829, all corporations incurring losses will receive an unwarranted penalty. Therefore, we suggest that the restriction on payment of interest aspect of your proposal be abandoned.

Two other changes need clarification. The first regards IRS authority to impose magnetic tape reporting on persons filing large numbers of returns (S&L institutions). Some of our institutions are still filing paper returns, not because of choice but because of cost. Will exceptions be made for those small institutions which might not be able to absorb even these processing costs in today's economic conditions? Secondly, because of all the reasons against withholding mentioned earlier, why impose withholding on depositors who fail to supply the proper social security number when a direct penalty would accomplish the same objective of increased compliance?

The U.S. League greatly appreciates this opportunity to present its views to the Committee on Ways and Means.

Statement of the Westchester County Industrial Development Agency

AN OVERVIEW—INDUSTRIAL DEVELOPMENT BONDS

Westchester County welcomes the opportunity to present its views on the value and benefits of industrial development bonds (IDBs). The IDB program is a clear example of how the private/public partnership can succeed in economic development. It is a financing vehicle that, by its own definition, combines the energies and resources of private industry in cooperation with a public benefit corporation to generate economic growth in a community.

IDBs assist localities to create and maintain a tax base. IDBs help create and maintain jobs. IDBs spur an overall demand for additional jobs and business services.

The IDB program works because it makes sense to business and can be administered in an efficient business-like manner.

REVENUE RAISER OPTIONS

It is important to recognize the basic effect of IDB financing. Local communities are being forced to investigate new avenues of revenue raising. Presently, three avenues are open to localities faced with budgetary pressures. The first alternative is to reduce the quality and level of government services. A second choice is to raise taxes. Either of these options render an additional burden upon local citizens. The final possibility is to increase the tax base by creating new economic activity. That is where the IDB program makes a significant contribution..

HISTORY OF WESTCHESTER IDA ACTIVITY

As illustrated in the accompanying statistical analysis,[1] IDB activity promotes economic forces in the form of increased property taxes, payroll-generated Federal and State income taxes, and State and local sales taxes. These items result in meaningful gains for local, State and Federal treasuries while stimulating long-term economic progress for the community and general area.

Primary benefits—completed issues

The Westchester County IDA, in three years of full operation, has issued bonds that have created and maintained 2504 jobs with a total annual primary payroll of $38 million. Conservatively 25 percent of that payroll is directly attributed to IDA issues and is so reflected as $9.5 million in Appendix A. Assuming a 20 percent marginal tax rate, the IDB financings result in $1.9 million of Federal Income Taxes. These financings also generate State income taxes, at a marginal tax rate of 5 percent, of $475,000. State and local sales taxes, computed on a marginal tax rate of 2 percent, produce gains of $190,000, under the described formula.

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[1] App. A.

Secondary benefits—completed issues

In addition, IDB financings generate vital secondary benefits, based upon the ratio of 3 new jobs being created by each IDB-related job. With the same formulae as stated above the IDBs will produce Secondary Federal Income Taxes of $5.7 million, based upon new secondary payrolls of $28.5 million. The State income tax would garner $1.4 million, and the State and local Sales taxes would be $570,000.

Primary benefits—pending issues

Currently, the Westchester IDA has IDB issues in the total amount of $58 million in progress.

These issues will result in primary payrolls of $8.5 million. Based on the same formulae, Federal Income Taxes of $1.7 million will be produced, the State Income Tax will produce $425,000, and State and local Sales Taxes will add $170,000.

Secondary benefits—pending issues

Utilizing the ratio of 3 new secondary jobs being created by each IDB-related job, the pending Westchester IDBs will produce Secondary Federal Income Taxes of $5.1 million, State Income Taxes of $1.2 million and State and local Sales Taxes of $510,000, applying the previously referenced standard rates.

Solid waste facility

35 municipalities throughout Westchester have entered into an agreement with the County to contract for the building of a plant that will safely incinerate garbage and produce elctricity as a byproduct. This Special Purpose Pollution Control Project will provide 1500 construction jobs and, ultimately, 3000 permanent jobs within a contemplated Industrial Park to be build adjacent to the Resource Recovery Plant.

The project's primary payroll will provide $5.7 million with Federal Income Taxes of $1.14 million, State Income Taxes of $285,000 of State and local Sales Taxes of $114,000.

The Industrial Park will provide a payroll of $45.6 million with $9.12 million Federal Income Taxes, $2.28 million State Income Taxes, and State and local Sales taxes of $912,000.

Payments in lieu of property taxes

Gains in the property tax base are indirectly registered through payments in lieu of property tax. Based upon an average Westchester County property tax, and after subtracting the soft financial costs pertinent to IDB projects, $1.9 million is created on completed issues while $2.3 million will be created on projects pending and $5.25 million by the Solid Waste Facility.

Clearly, IDB's do not represent a subsidy for business

Although IDBs finance a relatively small proportion of total capital outlays each year, the low-interest finance rate IDBs provide is often pivotal to expansion activity. IDBs reduce the cost of capital, which surveys indicate is the key element in expansion decision-making.

IDBs often mean the difference to the medium-sized company seeking to expand. In New York State, the average IDB issue is $5.5 million and the average low issue is $475,000, illustrating that IDBs usually are the financing impetus for the medium-sized firm.[2] The medium-size firm of the type that have been assisted in the vast majority of Westchester IDA issues, as documented by the accompanying report on Westchester IDA activity. Westchester IDA financings have been conducted in 19 Westchester communities and have primarily helped existing blue-collar employers to remain and grow in the County and New York State.

IDBS UNDER ATTACK

For the past year, officials responsible for the orderly management of IDB agencies have been obliged to continuously prove that IDBs serve an economic need, and are not, indeed, a subsidy for big business.

The IDB program is already over-burdened by regulation. It has a capital limitation that automatically restricts the use of the program. It has more than adequate restrictions pertaining to the use of an IDA facility. Now proposals are being made that would result in IDBs becoming less available to expanding companies. In a difficult business environment that requires flexibility and innovative approaches to stimulate business growth, some are proposing additional restrictions to further constrict IDB activity.

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[2] Municipal Finance Study Group—SUNY, Albany 1981

Over-regulation of any program results in its demise. The proposed new government regulations would serve to do just that.

We call your attention to the tax exempt Federal Housing IDB program which was essentially killed by over-regulation in 1980. Currently, the President is seeking to liberalize those regulations in Housing financings in an effort to resuscitate a failed financing program.

We would suggest a careful review of the genuine effects of the IDB program before subjecting the program to a fate similar to that of the Housing program.

Loss of federal tax revenues

A common criticism of IDBs emphasizes the loss of tax revenues because of the tax-exempt nature of the financings. This loss is estimated by the Congressional Budget Office (CBO April 1981 report on Small Issue Industrial Development Bonds) to be an annual loss of 3 percent of the total amount of IDB issues.

Following the CBO's formula, the loss to the Federal Treasury from Westchester IDB issues completed would be $1.4 million. The accompanying chart illustrates that the IDBs would produce $1.9 million in Primary Federal income tax and $5.7 million in Secondary Federal income tax. Clearly, the IDBs have actually contributed to the Treasury rather than to have served as a negative influence. It is also important to re-emphasize the flow back contributions made by IDBs in the form of State and local taxes and payments in lieu of property taxes.

Tax-exempt investments against taxable investments

Another view of IDBs points out that Federal taxes are lost through the tax-exempt IDB instrument and that, in the absence of such an investment opportunity, those tax-exempt monies would be placed in tax-bearing situations. Assuming that the average investor active in this field would be in the 50 percent tax bracket, it is logical to predict that such an investor would seek out alternate tax-exempt instruments. Thus, a much smaller aggregate total of such funds would accrue to the U.S. Treasury.

Competition for general obligation municipal bonds

The claim is often made that IDBs constitute strong competition for general obligation municipal bonds. In the past few years, IDBs have increased in volume in the tax-exempt market. However, IDBs and general obligation municipal bonds combined represent only a small part of the tax-shelter investment opportunities available to either corporations or individual investors. Thus the presence of IDBs is not necessarily a major factor affecting general obligation municipal bond performance.

In addition to noting the minor impact on the overall municipal bond market, it is important to consider that the viability of IDBs rests with the financial strength of the company guaranteeing the bonds, rather than with the credit status of the municipality in which the facility is situated.

States and localities experiencing difficulty in obtaining attractive rates on general obligation bond issues are doing so because of current financial market conditions and respective credit ratings not necessarily because of locally issued IDBs.

IDBs are neither a source of direct competition for these monies nor are IDBs causing a flood on the bond market. IDBs serve specific needs involving business growth and do not adversely affect the availability of funds for general obligation purposes.

RECOMMENDED IMPROVEMENTS TO THE IDB PROGRAM

Rather than acting to kill or cripple the IDB program, Westchester County believes certain improvements can be made in IDB procedures to maintain and strengthen an invaluable local development financing tool. At stake is the viability of a tax and economic base generating force of value to both government operations and to the economic vitality of individual areas.

Annual report of IDB activity

Westchester IDA agrees with the requirement to submit an annual report of small-issue IDB financings to the Federal and State governments. However, we advise against other restrictive bureaucratic measures that could only add to government delay and over-regulation.

Approval of a public body

Westchester IDA agrees with the concept of a local public body approving IDB projects. The Westchester IDA regulations guarantee the locality total control and approval over potential IDB projects. Each locality receives a 30-day notification

letter from the WCIDA. If the project is not disapproved within 30 days, it then proceeds. All meetings of the IDA Board are open public meetings.[3]

Commercial category

Perhaps the chief criticism of IDBs has centered upon the financing in inappropriate or questionable commercial projects. In some areas of the country, IDBs have beed used to finance fast-food shops, discount retailing outlets and similar establishments that would have pursued expansion without the benefit of tax free, low-cost financing.

The Westchester IDA, recognizing that confusion exists as to definition of the term "Commercial", formulated its own Guidelines for Commercial Projects.[4] These Guidelines mandate that a commercial applicant address the aspect of inducement, the economic feasibility of the project, and comply with all local, State and Federal development plans. Our Guidelines prohibit speculative projects and require proof of the long-term commitment of the project to the community. An independently prepared market study to support the application must be provided, and the Guidelines require 60-day evaluation for an application.

The Guidelines approach which we have adopted in Westchester has insured proper use of the Westchester IDB program, and indeed while Westchester activity has been primarily in the manufacturing and warehousing categories, the Agency has been able to assist the growth of appropriate commercial companies.

HINDRANCES TO THE IDB PROGRAM

Accelerated tax depreciation against IDB

Westchester IDA believes it would be counter-productive to force potential IDB applicants to choose between IDB financing and the accelerated tax depreciation credits provided in the Federal Economic Recovery Act of 1981. The availability of a "package" of programs designed to encourage business expansion is often essential to the success of a local economic development effort. Both low-cost financing and appropriate tax benefits, subject to local approval, are needed. The attached study (Appendix E) indicates that if a company is required to choose between Accelerated Tax Depreciation Credits and IDBs, it will choose Tax Credits. Quoting the Study: "Only if the differential between tax-exempt and taxable interest rates reaches 7 percent, or if the borrower is in the lower Federal corporate tax brackets, is an IDB election likely to be made. . . . Thus in the typical case the borrower will elect ACRS over IDBs if forced to choose." In essence, this requirement will effectively kill the IDB program.[5]

Financial contribution by a government body

We do not agree with a proposed requirement mandating a financial contribution or commitment to IDB issues by any government body. Such action itself would bring a negative impact to the general obligation municipal bond market and weaken the private/public partnership in economic development that Westchester County is committed to maintain. Such action would also add another layer of governmental deadly and control and serve to be counter-productive to orderly business expansion. In New York State it is illegal for a municipality to make a financial contribution.

CONCLUSION—"FINE TUNING"—NOT "KILLING" OF IDB'S

The Westchester IDA is convinced the IDB financing program is functioning effectively and to the optimum economic benefit for those companies and communities served, for the primarly and secondary payrolls assisted, and for the various taxing jurisdictions which receive increased tax revenues.

The limited market for IDB bonds affords adequate guarantee against overuse and abuse.

The added measures discussed would more precisely control the use of IDBs and would add the "fine-tuning" necessary to keep a meaningful program intact and healthy. The Federal government should also rely on the moral suasion of the concerned financial community, including investors, bankers and other professionals to monitor any apparant abuses occurring on a nationwide basis.

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[3]App. C.
[4]App.
[5]App. E.

Westchester is proud of its IDA record and believes that a close examination of the benefits produced by IDBs in Westchester County will confirm the bottom line economic contribution of a properly operating IDB financing program.

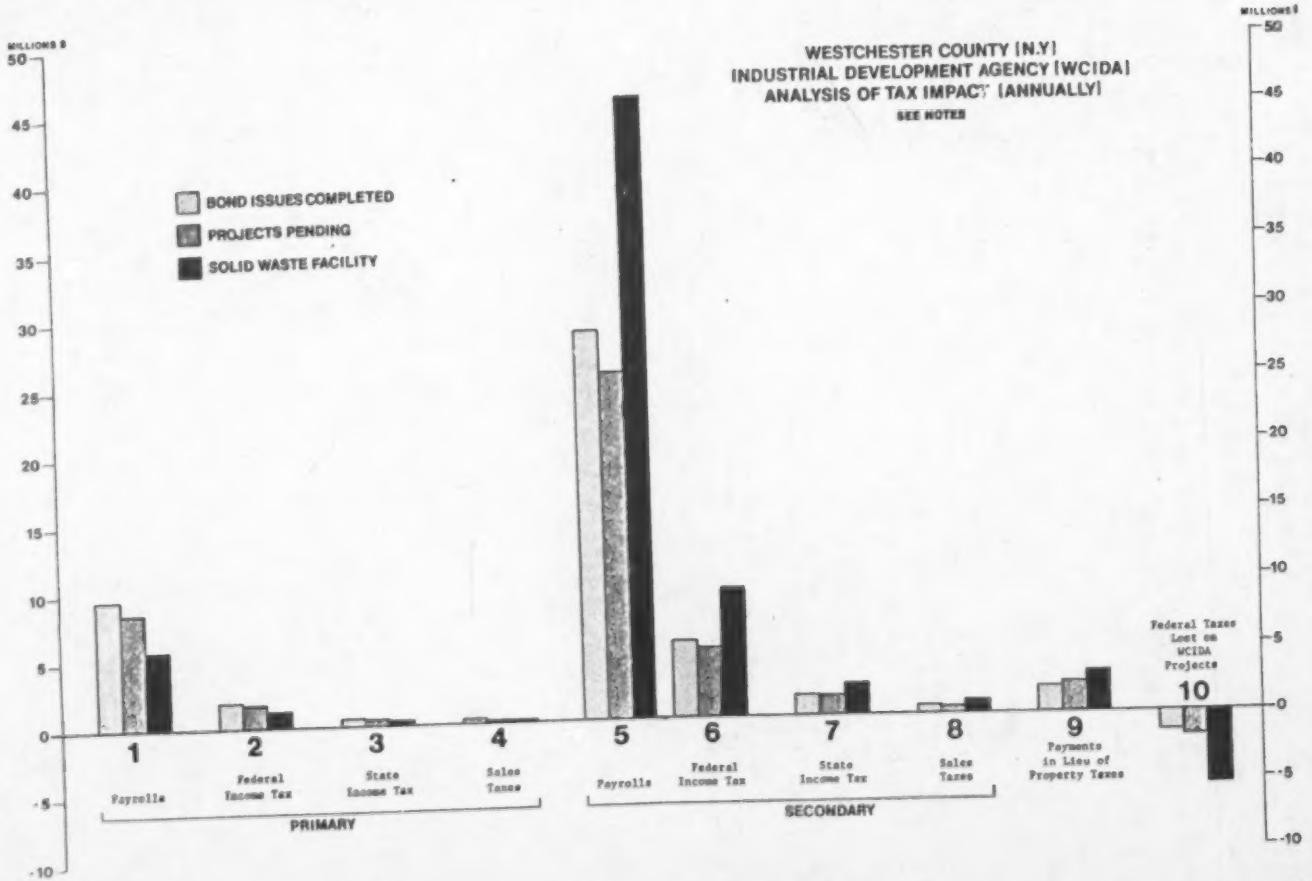
APENDIX A

TABLE I.—WESTCHESTER COUNTY (NEW YORK) INDUSTRIAL DEVELOPMENT AGENCY (WCIDA) ANALYSIS OF TAX IMPACT (CALCULATED ON AN ANNUAL BASIS)

See notes		Bond issues completed ($47 million)	Projects pending ($58 million)	Solid Waste facility ($175 million) [1]
1	Primary payrolls	9,500,000	8,500,000	5,700,000
2	Primary Federal income tax	1,900,000	1,700,000	1,140,000
3	Primary State income tax	475,000	425,000	285,000
4	Primary State and local sales tax	190,000	170,000	114,000
5	Secondary payrolls	28,500,000	25,500,000	45,600,000
6	Secondary Federal income tax	5,700,000	5,100,000	9,120,000
7	Secondary State income tax	1,425,000	1,275,000	2,280,000
8	Secondary State and local sales tax	570,000	510,000	912,000
9	Payments in lieu of property taxes	1,900,000	2,300,000	3,000,000
10	Federal taxes lost on WCIDA projects: 3 percent formula	1,410,000	1,740,000	5,250,000

[1] This special purpose pollution control project will receive funding as follows: New York State Department of Environmental Conservation, $27,865,000; Wheelabrator-Frye, Inc., $51,000,000; U.S. Economic Development Administration, $750,000.

Secondary payrolls and attendant tax figures are based on the construction of an adjacent industrial part with the creation of 3,000 permanent jobs.


WESTCHESTER COUNTY (N.Y.)
INDUSTRIAL DEVELOPMENT AGENCY (WCIDA)
ANALYSIS OF TAX IMPACT (ANNUALLY)
SEE NOTES
MILLIONS $
BOND ISSUES COMPLETED
PROJECTS PENDING
SOLID WASTE FACILITY
50
45
40
35
30
25
20
15
10
5
0
-5
-10
1 Payrolls
2 Federal Income Tax
3 State Income Tax
4 Sales Taxes
PRIMARY
5 Payrolls
6 Federal Income Tax
7 State Income Tax
8 Sales Taxes
SECONDARY
9 Payments in Lieu of Property Taxes
Federal Taxes Lost on WCIDA Projects
10

Notes to Table I and Charts

Westchester County (New York) Industrial Development Agency (WCIDA) and Analysis of Financing Activity Impact (Calculated on an Annual Basis)

Positive Economic Gains

1. Primary Payrolls—25 percent of the actual payrolls directly attributed to IDA financings.
2. Primary Federal Income tax—20 percent Standard Marginal Tax Rate applied to factored IDB payroll figure.
3. Primary State Income Tax—5 percent Standard Marginal Tax Rate applied to factored IDB payroll figure.
4. Primary State & Local Sales Tax 2 percent Standard Marginal Tax Rate applied to factored IDB payroll figure.
5. Secondary Payrolls—Based upon 3-to-1 Standard Multiplier.
6. Secondary Federal Income Tax—20 percent Standard Marginal Tax Rate applied to factored IDB payroll figure.
7. Secondary State Income Tax—5 percent Standard Marginal Tax Rate applied to factored IDB payroll figure.
8. Secondary State & Local Tax—2 percent Standard Marginal Tax Rate applied to factored IDB payroll figure.
9. In Lieu of Property Tax Payments—Based upon average property tax rate in Westchester County.
10. Federal Revenues Lost on IDB Projects—based upon Congressional Budget Office Estimate, April 1981 Report, "Small Issue Industrial Development Bonds," 3 percent of total bond issues (per year).

APPENDIX B

WCIDA BOND ISSUES

[Number of companies, 16; total to date, $46,770,000; total affected to date, 2,504]

Company	Date	Issue	Term (years)	Rate (percent)	Affected	Purchaser	Trustee
Sound Distributing Corp., Yonkers	11/1/78	500,000	10	8½	140	Chemical Bank	NBW.
Ordibel, Inc., Greenburgh	12/22/78	1,000,000	10	7¼	160	NBW & others	Lincoln First Bank of Rochester.
Pennwalt Corp., North Castle	4/5/79	4,800,000	30	6.9	165	Goldman Sachs	Girard Bank, Philadelphia.
Filex Steel Products Co., Inc., Village of Ossining.	5/9/79	600,000	20	8	250	Bank of New York	Bank of New York.
Kings Electronics Co., Inc., Tuckahoe	1/30/80	1,700,000	12	10	500	National Bank of North America	National Bank of North America.
Niloc Operating Co., (Colin Service Systems, Inc.), White Plains.	6/13/80 5/1/81	1,300,000 300,000	20	8	65	Bank of New York	Bank of New York.
Top-All Varieties, Inc., White Plains	6/27/80	400,000	20	10	85	Scarsdale National Bank, Nanuet National Bank Westmoreland Realty Co.	Irving Trust Co.
Selecto Products Co., Inc., Ardsley	8/26/80	650,000	15	10	70	Bank of New York	Bank of New York.
Ardmar Realty Co., Tuckahoe	1/22/81	1,000,000	15	8½	75	NBW, Lincoln First Bank Bank, N.A	Lincoln First Bank, N.A.
Marvin Glauber (Interstate Building Materials), Irvington.	1/22/81	750,000	20	8	15	Bank of New York	Bank of New York.
George Lane, (Electro Materials Corp.) Village of Mamaroneck.	3/5/81	1,000,000	15	10½	65	Chemical Bank	J. Henry Schroder Bank & Trust Co., New York City.
AGR Realty Co., Yonkers	4/14/81	17,000,000	20	10	550	Bank of New York	Bank of New York.
Caper Litho, Inc., Village of Elmsford (Equipment).	6/5/81	1,620,000	7	10½	91	Marine Midland Bank, N.A., N.Y. City	Marine Midland Bank, N.A., N.Y. City.
Royal Copenhagen (W) Porcelain Corp., White Plains.	7/31/81	840,000	10	[1] 65	33	Manufacturers Hanover Trust Co.	Connecticut Bank & Trust Co.
HRCC, Inc. (C) (SCM Corp.), Village of Ossining.	9/10/81	5,310,000	3	10½	90	Blyth Eastman, Paine Weber	Marine Midland, N.A.
Hitachi Metals (C) International, Inc., Harrison.	10/14/81	8,000,000	10	[2]	150	The Bank of Tokyo Trust Co.	The Bank of Tokyo Trust Co.

[1] 65 percent of prime. [2] Approximately 60 percent of prime.

PROPOSALS INTRODUCED BY WCIDA

[Inducement totals: number of companies, 18; amount, $234,763,025; jobs, 3,815]

Company	Amount	Jobs affected	Induced
Saw Mill River Industries Inc., Yonkers	$725,000	310	5/19/80
Barker Avenue Associates, White Plains	9,864,000	95	6/16/80
Savin Corp., Mount Pleasant	7,000,000	375	6/24/80
Simmonds Precision Products, Inc., North Castle	9,330,000	100	6/24/80
Hawthorne One Co. (International Furniture Rentals), Mount Pleasant	1,600,000	80	8/4/80
Solid Waste Management Plant, Peekskill	175,000,000	1,500	12/31/80
TCR Service, Inc., Croton-On-Hudson	1,250,000	50	1/14/81
Duroyd Manufacturing Co., Yonkers	427,200	150	2/25/81
Modern Tobacco Industries, Inc., Port Chester	1,800,000	105	2/25/81
Midtown Manufacturing Corp., Town of Cortlandt	725,000	100	4/30/81
Robert Martin Co. (Grand Union), Village of Tarrytown	993,000	60	7/30/81
Two C Caterers, Inc., Town of Mamaroneck	1,424,500	70	7/30/81
Rye Land Associates, City of Rye	4,890,000	175	9/2/81
Jenaer Glaswerk Schott & Gen., Inc., Yonkers	3,000,000	60	9/2/81
Artina Realty (OCR Tax Systems), Elmsford	2,775,500	135	11/24/81
Information Displays, Inc., North Castle	1,250,000	175	11/24/81
Eastern Container Corp., Elmsford	9,800,000	100	11/24/81
Automatic Film Processor Corp., Town of Bedford	1,708,825	100	2/26/82
Marshall Klein and Samuel H. Klein d/b/a Emes Associates (Crown Products Co.), City of Yonkers	1,200,000	75	2/26/82

[1] Deferred to Mount Pleasant Industrial Development Agency.

APPENDIX C

CONSOLIDATED LAWS SERVICE

History: Add. L 1976, ch 787, eff July 24, 1976.

§923-a. County of Westchester industrial development agency

For the benefit of the county of Westchester and the inhabitants thereof, an industrial development agency, to be know as the County of Westchester Industrial Development Agency, is hereby established for the accomplishment of any or all of the purposes specified in title one of article eighteen-A of this chapter. It shall constitute a body corporate and politic, and be perpetual in duration. It shall have the powers and duties now or hereafter conferred by title one of article eighteen-A of this chapter upon industrial development agencies and provide that the exercise of the powers by such agency with respect to the acquisition of real property whether by purchase, condemnation or otherwise, shall be limited to the corporate limits of the county of Westchester and such agency shall take into consideration local zoning and planning regulations as well as regional and local land use plans. The agency shall not use its funds to commence any project unless (i) at least thirty days' prior notice of such project shall have been given to each local municipality in which a part or parts of the project is, or is to be located and (ii) no objection, by resolution of the governing body of such municipality, shall have been made and delivered to the agency within such thirty days. Notwithstanding the provisions of the next preceding sentence, in the case of a project which is, or is to be, located within a village within the county of Westchester, notice to such village shall be sufficient as to any part or parts of the project within the village and no other notice shall be required to be given to any other municipality in which such village is located with respect thereto. It shall be organized in a manner prescribed by and be subject to the provisions of title one of article eighteen-A of this chapter. Its members shall be appointed by the chief executive officer of the county of Westchester, subject to confirmation by its governing body. The agency, its members, officers and employees, and its operations and activities shall in all respects be governed by the provisions of title one of article eighteen-A of this chapter.

History: Add. I 1976, ch. 788, eff. July 24, 1976.

Appendix D

County of Westchester Industrial Development Agency

Guidelines for Commercial Projects

PART I

Policy and standards

Section 1.1. *Purpose.* These guidelines have been approved by the County of Westchester Industrial Development Agency in order to establish the procedures, policies and standards under which it will evaluate applications for assistance in financing commercial projects through industrial development bonds under the New York State Industrial Development Agency Act and the Agency's enabling act (Article 18A and Section 923a of the General Municipal Law, the "Act").

Section 2.1. *Authority.* These guidelines have been approved by a resolution duly adopted by the Agency under the Act, and apply to all proposed projects presented for the Agency's consideration after April 1, 1980.

Section 2.3. *Policy and Standards.* (A) In evaluating commercial projects for bond financing, the Agency will require applicants to demonstrate to its satisfaction that:

(1) The financing will induce the location or expansion of the project in the area it will serve.

(2) The economic feasibility of the project will be seriously and substantially impaired without the availability of bond financing.

(3) To the extent the project serves a local market area, there is a recognized and demonstrable need for the products or services the project will provide in the project's market area.

(4) The project is compatible with and will significantly assist and enhance all development plans for its area established formally or informally by local, County, State and federal authorities.

(5) There will be no significant disruption of existing employment or competitive facilities in the area in which the project is located.

(6) The project will initially provide substantial employment, substantial capital investment, and a substantial increase in the property tax base, and be of a nature which demonstrates a substantial long term commitment of the beneficiary to the County and which makes its highly likely that the substantial increase in employment, investment and tax base will continue for at least 15 years. Initial increases in employment of less than 50 and initial capital investments of less than $1 million will not be considered substantial.

(7) The project is not of a speculative nature.

(B) Projects which do not qualify under Section 2.3(A) will nonetheless be considered further by the Agency if it is demonstrated that (1) there is a critical or extraordinary need in the area for the project or its products or services or the employment it will create, (2) the project is a major element in an approved urban renewal plan, or (3) the project otherwise represents a unique and special enhancement of the facilities or employment opportunities available in the County.

PART II

Procedures

Section 2.1. *Application.* Each applicant for assistance in financing a commercial project shall complete the portion of the Agency's application relating to commercial projects in full detail. There shall be a complete discussion satisfactory to the Agency of all factors bearing upon the project's qualification under the policies and standards set forth in Section 2.3 of these guidelines.

Section 2.2. *Market Study.* As a supplement to the application, the applicant shall submit a recent, competent market or economic impact study prepared at the applicant's expense. The Agency may require the study to be prepared by an independent party. The study shall assist the Agency's determinations under these guidelines, and support the information presented and representations made in the application.

Section 2.3 *Evaluation.* The Agency requires at least 60 days following submission to review applications for commercial projects. Determinations of eligibility for financing will be made as soon thereafter as is practicable.

Section 2.4 *Other Policies.* All other policies and practices established by the Agency for its projects generally shall apply as well to commercial projects. These

include particularly those relating to the procedures for the issuance of its bonds and applicable legal requirements.

APPENDIX E

IDB's vs. ACRS: A COMPARATIVE ANALYSIS

Among proposals to legislatively restrict tax-exempt small issue industrial development bonds ("IDB's"), one currently under study involves requiring a borrower to elect between IDB financing of a project and the Accelerated Cost Recovery System ("ACRS") method of depreciating the project assets. If no IDB financing is involved, the borrower could use ACRS; if the project is financed by IDB's, the alternative depreciation methods ("Alternative Depreciation") provided in the Economic Recovery Tax Act of 1981 would apply.

This analysis seeks to evaluate whether a borrower is more likely to elect IDB's or ACRS in a typical case using varying assumptions. Only a case involving real property was examined. The IDB vs. ACRS proposal would almost certainly eliminate IDB financing of equipment. The rapid write-offs for equipment, the investment tax credit and their saleability under the Tax Act create such clear advantages to corporations in the short term that the election would normally go against IDB financing of equipment.

Summary.—Based on our analysis, if required to elect between ACRS and IDB's, few companies would elect IDB financing for real property. ACRS generally would represent the less costly alternative. Only if the differential between tax-exempt and taxable interest rates reaches 7 percent, or if the borrower is in the lower federal corporate tax brackets, is an IDB election likely to be made. It is our understanding that the rate differential is not now near the 7 percent level, and that most IDB borrowers are in the highest (46 percent) federal corporate income tax bracket. Thus, in the typical case the borrower will elect ACRS over IDB's if forced to choose. While this proposal would appear to allow IDB's to continue, it would in fact be uneconomical for borrowers in most conceivable situations to elect IDB's and forego ACRS.

Parameters of the Analysis.—The case we analyzed assumed the following parameters:

(1) A borrower proposes to construct a $1,000,000 industrial plant using a $1,000,000 IDB or taxable borrowing.

(2) The IDB or the taxable borrowing would have a term of either 15 years or 25 years, with level debt service amortization.

(3) The IDB would carry a 13 percent per annum fixed rate of interest, tax exempt.

(4) The taxable obligations issued in a conventional financing to finance the same project (or the attributable cost of internally generated funds) would carry rates of 16 percent, 18 percent or 20 percent per annum.

(5) ACRS permits the plant to be depreciated over a 15 year period based initially on a 175 percent declining balance method of recovery, switching to a straight line method at a time which will maximize the deduction allowable.

(6) The Alternative Depreciation schedule to ACRS permits the plant to be depreciated over a 35 or 45 year period based on a straight line method of recovery. For purposes of this analyses a 35 year recovery period was chosen.

(7) The borrower will examine available tax benefits using a 5 or 15 year time horizon on a present value basis using a discount rate equal to the taxable borrowing rate.

Summary Sheets—Exhibits A and B.—A Summaries of the results of our analysis are attached as Exhibits A and B. In these summaries we have complied information derived from 48 separate investment analyses prepared using a computer program designed expressly for this purpose.

Exhibit A sets forth present value cost of the project under ACRS and using IDB's with respect to a corporate borrower paving federal income tax at the maximum 46 percent rate. In Exhibit B, this information is presented for a 20 percent federal income tax.

Within each Exhibit, the summary information is presented in columnar form as follows:

The "Case Number" is the number of the case having the parameters indicated. The computer runs which demonstrate the present value cost of the project in each case on the assumed parameters are available as an Appendix to this analysis for those interested.

The "Rate Differential" parameter column indicates the assumed difference between the tax-exempt and taxable borrowing rates (3 percent, 5 percent and 7 percent as the differential between the assumed tax-exempt rate of 13 percent and the assumed taxable rates of 16 percent, 18 percent and 20 percent).

The "Loan Term" parameter column indicates assumed borrowing terms, whether tax-exempt or taxable, of 15 and 25 years.

The "Horizon" parameter column indicates the number of years (the "horizon") over which the borrower will make its financial analysis. These are assumed to be 5 years and 15 years. Short and long range perspectives are important because many IDB borrowers are small companies looking only to the short run. After 15 years, most loans will be terminated, by prepayment, refinancing or otherwise. Separate computer runs, not summarized, indicate that a 25 year horizon would not materially change the results of this analysis.

There are two "Present Value" columns. The "ACRS" Present Value column indicates the present value cost of the project, on the assumed parameters and using the taxable borrowing rate as the discount rate, if the borrower elects ACRS over IDB's. The "IDB" Present Value column indicates the present value cost, on the same assumed parametes, if IDB's are elected over ACRS. The ACRS and IDB columns in Exhibits A and B are the key columns, because the rational borrower will select the lower of the two present project costs shown.

ACRS vs. IDB's—Borrowers in the 46 Percent Federal Income Tax Bracket.—Exhibit A presents the present value cost of the project using ACRS and under IDB's where the borrower is paying federal income taxes at the rate of 46 percent. This Exhibit graphically demonstrates that the interest rate differential between the tax-exempt and taxable rates available to the borrower will be the critical factor in the borrower's election between ACRS and IDB's.

In cases 1–8, where the rate differential is 5 percent or less, IDB's are more costly than ACRS. Thus, for example, in case 6, where the rate differential is 5 percent the loan plant would have a present value cost of $467,226 and te ACRS plant a present value cost of $447,959. It is thus likely that, in this range and on a cost basis alone, the election would be against IDB's.

In cases 9–12, when the rate differential is 7 percent, IDB's represent a less costly alternative in cases 10, 11 and 12. In case 9, a borrower is better off using ACRS. Even at a 7 percent rate differential, therefore IDB's would represent a more attractive option only with longer bond terms and longer corporate horizons.

The tax-exempt and taxable rate differential varies over time depending on a number of factors, including those affecting the capital markets generally as well as those unique to the tax-exempt market. These include particularly the availability of other tax shelter alternatives and the demand for income sheltering investments. The nature and financial condition of the borrower is also a significant factor in the taxable and tax-exempt rate differential available to it.

This differential appears to have narrowed somewhat in the last year. Rate estimates by Salomon Brothers published in The New York Times on November 6, 1981 indicate a 3 percent rate differential (12.82 percent and 15.83 percent) between municipal bonds and Bell System Corporate Bonds. Municipal rates are thus currentially 81 percent of corporate, using these estimates.

From these estimates, and those provided by our clients issuing IDB's, it appears that most borrowers would probably face a rate differential of 5 percent or less. In these circumstances, the ACRS alternative would generally be preferable.

These tables also demonstrate that with shorter "horizons", the relative attraction of ACRS over IDB's increases. Cases 3 and 4, for example, involve rate differentials of 3 percent and loan terms of 25 years. Shortening the horizon from 15 years (case 4) to 5 years (case 3) increases the ACRS advance over IDB's from $54,078 ($369,488–$315,410) to $56,640 ($210,282–$153,642). As indicated earlier, we are advised by our IDB issuing clients that most small and medium sized corporations they work with have relatively short financial horizons. This would tend to make ACRS look even more favorable to such corporations.

The table further indicate that with shorter bond terms, the relative attraction of ACRS over IDB's also increases. Cases 2 and 4, for example, involve rate differentials of 3 percent and horizons of 15 years. Shortening the loan term from 25 years (Case 4) to 15 years (Case 2) increase the ACRS advantage over IDB's from $54,087 ($369,488–$315,410) to $63,020 ($515,905–$452,885). Shorter maturities are commom today, as long term money is increasingly scarce. This also would make ACRS more attractive.

ACRS vs. IDB's—Borrowers in the 20 percent Federal Income Tax Bracket.—Exhibit B (cases 13–24) demonstrates that, where the borrower's federal corporate income tax rate is 20 percent, the ACRS cost of the project is always greater than

the IDB cost, making IDB's the preferred alternative. Where the tax rate was 46 percent as in Exhibit A, ACRS is generally the preferred alternative.

This phenomenon basically reflects the more limited value of the depreciation deduction under ACRS to a tapayer in the lower tax brackets, ACRS deductions are more than twice as valuable to a corporate taxpayer in the 46 percent bracket as they are to one in the 20 percent bracket.

The corporate tax rate structure is somewhat progressive, with rates at 17 percent for taxable incomes up to $25,000, 20 percent from $25,000–$50,000, 30 percent from $50–75,000, 40 percent from $75–100,000 and 46 percent over $100,000. Taxpayers in the 20 percent bracket, for whom IDB's would be relatively attractive as indicated in Exhibit B, would thus have taxable incomes of less than $50,000. While we do not have sufficient information to determine the percentage of IDB users in the lower brackets, our experience indicates that it is quite small. IDB's would be elected over ACRS, then, only in a limited fraction of the cases.

Conclusion.—Our analysis demonstrates that IDB users in the 46 percent federal corporate income tax bracket should ordinarily elect ACRS over IDB's unless the differential between the tax-exempt and taxable borrowing rates reaches 7 percent. As most IDB users are in this tax bracket, the ACRS vs. IDB proposal in all likelihood would substantially curtain the IDB program.

EXHIBIT A

[Borrowing size: $1,000,000; tax-exempt bond rate: 13 percent; applicable corporate tax rate: 46 percent]

Case No.	Rate differential (percent)	Loan term (years)	Horizon (years)	Present value cost of the project	
				ACRS	IDB
1a, 1b	3	15	5	211,199	277,152
2a, 2b	3	15	15	452,885	515,505
3a, 3b	3	25	5	153,642	210,282
4a, 4b	3	25	15	315,410	369,488
5a, 5b	5	15	5	225,258	264,516
6a, 6b	5	15	15	447,959	467,266
7a, 7b	5	25	5	176,205	200,786
8a, 8b	5	25	15	332,039	336,417
9a, 9b	7	15	5	239,166	252,794
10a, 10b	7	15	15	444,356	425,824
11a, 11b	7	25	5	197,623	191,947
12a, 12b	7	25	15	347,017	308,078

EXHIBIT B

[Borrowing size: $1,000,000; tax-exempt bond rate: 13 percent; applicable corporate tax rate: 20 percent]

Case No.	Rate differential (percent)	Loan term (years)	Horizon (years)	Present value cost of the project	
				ACRS	IDB
13a, 13b	3	15	5	423,760	406,879
14a, 14b	3	15	15	762,124	711,951
15a, 15b	3	25	5	370,337	343,398
16a, 16b	3	25	15	653,995	590,572
17a, 17b	5	15	5	445,086	388,518
18a, 18b	5	15	15	759,982	648,482
19a, 19b	5	25	5	399,925	328,435
20a, 20b	5	25	15	670,777	538,881
21a, 21b	7	15	5	465,520	371,477
22a, 22b	7	15	15	758,415	594,070
23a, 23b	7	25	5	427,573	314,074
24a, 24b	7	25	15	685,007	494,474

APPENDIX

The data supporting the present value cost presentations in Exhibits A and B is presented in this Appendix. The Appendix consists of 48 separate computer runs

each entitled "Investment Analysis" demonstrating present value project costs on the assumed parameters. The case number is indicated in the upper right hand corner of each Investment Analysis. These run numbers correspond with the "Case No." columns on Exhibits A and B,

Terminology used on each "Investment Analysis" sheet has the following meanings:

"Tax Rate" means the federal corporate income tax rate applicable to the borrower.

"Term of Financing" means the assumed term of the tax exempt or taxable borrowing used to finance the project.

"Tax-Exempt Rate" means the rate of interest assumed for a tax-exempt borrowing used to finance the project. This is held constant at 13 percent for comparative purposes.

"Taxable Interest Rate" means the rate of interest assumed for a taxable borrowing (or attributed to internally generated capital) used to finance the project. These rates vary among 16 percent, 18 percent and 20 percent, to establish 3 percent, 5 percent, and 7 percent differentials from the tax-exempt rate.

"Financing Type ACRS" ad "Financing Type IDB" mean that the borrower will elect, respectively, either ACRS (and taxable borrowing) or IDB's (and Alternative Depreciation).

"Period" indicates the year number subsequent to the borrowing date.

"Interest" indicates the amount of interest payable on the assumed borrowing.

"Principal" indicates the amount of principal payable on the assumed borrowing.

"Depreciation" indicates the amount of depreciation on the project under the applicable method (ACRS—no IDB's, or Alternative Depreciation—with IDB's).

"Tax Benefit" is the sum Interest and Depreciation multiplied by the Tax Rate, and indicates the dollar value attributable to the interest and depreciation deductions available to the borrower.

"Cash Flow" indicates the actual dollar cash flow payable by the borrower in the transaction, calculated as the tax benefit (shown as a positive number) less interest and principal payments (shown as negative numbers).

"PV Factor" means the present value factor applied to establish the present value of the Cash Flow over the assumed Horizon using a discount rate equal to the assumed taxable borrowing rate.

"Present Value" indicates the present value of the cash flow in the period shown.

"Totals" show, under the "Present Value" column, the total present value cost of the project under the assumed parameters. The Present Value Total is the amount which appears in Exhibits A and B for summary and comparison purposes.

[NOTE.—Computer runs have been omitted, but are available to anyone interested.]

WISCONSIN ASSOCIATION OF MANUFACTURERS & COMMERCE,
March 29, 1982.

Hon. CLEMENT J. ZABLOCKI,
U.S. House of Representatives,
Washington, D.C.

DEAR REPRESENTATIVE ZABLOCKI: The Federal Tax Subcommittee of the WMC recently reviewed certain Administration and other tax proposals. Hopefully, after you have considered our position on these proposals, you will find our positions merit your support.

Given the fact the Economic Recovery Tax Act ("ERTA") of 1981 departed from the past practice of giving $3 of individual tax relief for every $1 of business tax relief (the 1981 ratio was $4: $1), we are especially concerned with the substantial burden these proposals place on business. The Administration's proposals alone seek to recover 56 percent of the tax benefits given business in 1981 (73 percent of such benefits if only incorporated businesses are considered). We believe the need to enhance America's productivity and thereby its international competitive position by encouraging the modernization of our plants and equipment is no less needed in 1982 than it was in 1981.

Administration tax proposals

1. We oppose the Administration's proposal for enactment of an alternative minimum tax. It is based on the faulty assumption that there is "a better measure of income" with respect to which this alternative tax should apply. In addition to the potential for mischief inherent in redefining "income" for the purpose of levying this new alternative tax, the thrust of the proposal is to substantially reduce the

beneficial impacts of the investment tax credit as a stimulant to new investment in productive plant and equipment. The enumeration of "preference items" constitutes a list of specific items which were enacted to further Congressionally determined meritorious goals (e.g., the stimulation of exports in the case of DISC income). If in fact any of the deemed "preferences" are found to no longer further U.S. economic policy, it would appear far more appropriate to address those particular provisions of our existing tax law than to overlay this new alternative minimum tax and its attendant complexities on the entire corporate sector. The proposal would deepen cyclical downturns as reduced "normal income" could result in further reductions in capital expenditures due to (1) cash outflow to discharge minimum tax liability and (2) the fact that investment tax credits do not reduce minimum tax liability. Finally, the new alternative minimum tax proposal would create inequities as two companies may have exactly the same amount of "preference" income and investment tax credit—and yet one company would not be subject to any minimum tax because of its other business income while the second company would be required to pay the tax.

2. We oppose the proposed repeal of the completed contract method of accounting and the adoption of more onerous Regulations for deducting current or period cost by taxpayers involved in long term contracts. In addition to substituting extremely complex tax accounting requirements for an existing system of long term contract tax accounting requirements for an existing system of long term contract tax accounting rules, the Administration's proposal will have a very disproportionate impact on those companies engaged in construction, national defense, and the production of specialty products which require more than one year to manufacture. For these companies, the apparent impact in cost may be in the magnitude of ten times the total tax benefits they reveived under ERTA. To the extent that federal, state, or local governments are customers for products covered by this proposal, a U.S. producer must reflect this increasd cost in its pricing to these customers. Unlike other business taxpayers using the accrual shipment method of tax accounting, those engaged in long term contracts will be denied current year tax deductions for a portion of their current year's interest expense, general administrative expense, etc., under the Administration's proposals. If certain abuse situations do exist under existing regulations, it is respectfully submitted that either the federal government change it own contracting procedures or the Treasury issue appropriate interpretative rulings to deal with such abuses.

3. We oppose the proposed accelereation of corporate income tax payments which appears based on a faulty assumption—that corporations are able to accurately estimate their taxable income "on a monthly basis." In point of fact, the proposed acceleration of corporate tax payments can only result in many corporate subject to underpayment penalties. The proposal appears to approximate a one percentage point increase in the corporate tax rate. It also places an undue burden on corporations to determine taxable income with a degree of accuracy at times clearly beyond the ability of many corporate taxpayers—especially those having numerous business locations and/or extensive non-U.S. operations.

4. With respect to the Administration's proposals to reduce or repeal business energy tax incentives, time did not permit a detailed analysis of eacn of the tax incentives which would be impacted by the Administration's proposals. We do believe that this country should have a consistent long term energy policy and that tax incentives could play a meaningful role in this policy. A program of "on-again, off-again" tax incentives is inconsistent with the need for such a long term energy policy.

5. If there is a need to discover unreported income and to accelerate cash flow to the government, we believe that a withholding tax on dividends and interest may appropriately meet this requirement. We suggest a 10 percent withholding rate rather than the Administration's 5 percent rate as a more convenient and probably a more appropriate rate. Administrative costs incurred by withholding agents could be eased by those burdened by this withholding requirement.

6. If there is a need for additional federal revenue, we would support the capitalization of construction period interest and property taxes rather than their immediate deductibility. While preferring to continue the existing expensing treatment, we view such capitalization proposal as a "lesser evil" than other proposals mentioned herein.

7. As to the restrictions proposed by the Administration with respect to the issuance of tax exempt industrial development bonds, we accept the need to avoid abuses in the use of such bonds. To the extent the Administration's proposals correct demonstrated existing abuses, we would support the Administration proposals.

Other proposals

1. We oppose any changes in the safe harbor leasing provisions until the U.S. Treasury Department has completed its study and has made public the results of such study. If the Treasury study clearly shows areas of abuse, such particular abuses should be corrected. Any changes in the safe harbor leasing provisions should be made prospectively and not retroactively.

2. We oppose the proposal first contained in the Dole-Grassley Bill (S.B. 2198), introduced in the House as H.R. 5829, to deny interest to taxpayers on net operating loss or tax credit carrybacks. To now change the rules so as to penalize business taxpayers who have just incurred substantial losses in 1981 can be viewed as equivalent to a tax increase on loss companies. Furthermore, a taxpayer required to pay tax on an audit deficiency due to a court decision rendered or an IRS Regulation issued, say, three years after the date the tax return was filed, must pay interest on the deficiency calculated from the date the tax was initially due. To deny taxpayers interest from January 1 following the year of incurring a loss or excess credit giving rise to a carryback is certainly inequitable.

3. We also oppose the proposal first contained in the Dole-Grassley Bill (S.B. 2198), introduced in the House as H.R. 5829, to levy a 10 percent penalty on any tax due above a threshold amount which arises out of an audit and is not attributable to a "disclosed item." Many returns are too complex and the law uncertain to invoke such a penalty, absent any showing of negligence. In 1981, the Congress added additional penalties for negligent conduct in the filing of tax returns. The proposal appears to be an "overkill" insofar as it goes beyond the existing 20 percent interest cost due on audit deficiencies not arising out of negligent or fraudulent conduct. Taxpayers cannot be expected to file tax returns by the prescribed due dates and yet conduct a tax audit of the financial books of account of a company. Corporate taxpayers already file a "Schedule M" which sets out all tax return deviations from the corporation's financial books of account. At this time of significantly reduced business income, the safe harbor threshold amounts offer little solace to a business taxpayer seeking to timely fulfill his reporting responsibilities under our very complex self assessment tax system.

While we appreciate that an election year makes business generally more susceptible to onerous legislative proposals, we ask your support for the adoption of a rational tax policy. We submit that one of its objectives should be the building of a more productive American industrial base. While some have criticized the business community as not already responding to ERTA, is it any wonder that in light of the above proposals (forgetting for a moment our current overall economic situation) business is hesitant to invest?

I would appreciate the opportunity of discussing the above with you or a member of your staff at your earliest convenience. Wisconsin business, its employees and owners, needs your active support.

Respectfully,

CHARLES W. RAU,
Chairman, Federal Tax Subcommittee.

NICHOLAS WOOD & ASSOCIATES, INC.,
Bridgeport, Conn., April 12, 1982.

JOHN SALMON, Esq.,
Chief Counsel, Committee on Ways and Means,
Washington, D.C.

DEAR MR. SALMON: We wish to make three points with regard to the pending legislation pertaining to IRB financing.

81-216 should be rescinded. We believe many have already spoken to this point. We feel it is imperative that small businesses be allowed to aggregate their loans under state umbrella progams and thus reduce the cost of issuance.

High-tech firms who capitalize research and development costs should not have to include these costs for purposes of any capital expenditure tests. High-tech firms characteristically capitalize their R&D costs rather than expense them since they have little income initially to offset the R&D expenses.

The proposed three-year $20 million capital expenditure limit for the prior three years is satisfactory, but for the coming three years should be eliminated, since many firms could well exceed the $20 million limit within six years.

We feel strongly that the future growth in America is dependent on the new high technology firms who are just starting out. The Magazine Inc., whose audience is small business people, estimated in May 1981 that the top 100 publicly held, fastest

growing firms' work forces increased 663 percent in the previous five years compared to a 12 percent increase registered by the Fortune 500. Forty-six of the 100 fastest growing companies are involved in the manufacture of computer related products or medical equipment and pharmaceuticals. We mention all this to you on the Committee as developers and agents for nearly 3,000,000 square feet of industrial space for Fortune 500 companies and not as developers and agents for the smaller fast-growing companies we wish to see helped by our suggestions.

If this country is to regain some degree of leadership as an industrial nation, then we should do everything in our collective power to help new industry grow and prosper. Thank you for your kind consideration.

Yours sincerely,

NICHOLAS WOOD.

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